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## BOOK REVIEWS

### Income Taxation of Nonresident Aliens and Foreign Corporations

By Sidney I. Roberts and William C. Warren. PRACTISING LAW INSTITUTE, New York, N. Y., 1953. Pages: 129; $2.00.

Here is a new addition to the list of excellent pamplets published by the Practising Law Institute in their series "Current Problems in Federal Taxation." Messrs. Roberts and Warren have prepared an informative and useful book on how United States income taxes affect some types of foreign transactions. The title of the study—"Income Taxation of Nonresident Aliens and Foreign Corporations"—indicates its scope and, within the scope of these self-imposed restrictions, the treatment is quite complete.

This booklet continues the interesting device used in many of the Practising Law Institute publications of having the exposition of applicable rules of law grow out of a hypothetical set of facts facing certain individuals. This method serves to catch the interest of the average reader and lures him on from section to section of the booklet. Such a method has its draw-backs, however, and to a person, seeking information on some specific point, the interposition of the problems of the fictitious taxpayer into the statements of law may be somewhat confusing.

The presentation of the material is grouped under the following headings, which epitomize the comprehensiveness of this 129-page brochure:

Tax Patterns of Foreign Taxpayers
The Meaning of "United States" and "Foreign"
Primary Classification of Individuals
Engaged in Trade or Business in the United States
Source of Income
Fixed or Determinable Annual or Periodical Income
Deductions, Credits and Exemptions
Withholding of Tax at Source
Reductions in Rates and Exemptions Granted by Treaty
Foreign Tax Credit, Estate and Gift Taxes
Penalty Taxes
Returns

A closer examination of these sections leads to the conclusion that the authors have done a remarkable job of presenting a wealth of material in a complicated area of the tax law with a minimum of words. An example is the discussion on "Source of Income", one of the most vexatious problems in the field of foreign taxes and one of basic importance in the taxation of nonresident alien individuals and foreign corporations. Section 119 of

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the Internal Revenue Code, the statutory basis of most of the concepts in connection with the determination of the source of income, is made the subject of 34 pages of discussion. After pointing out that no class of income is exempt merely by reason of the failure of Sec. 119 to refer to such class, the authors discuss the criteria for determining the sources of both income of the several classes specified in Section 119 and income not specifically dealt with therein.

As an example of the complexity of this subject, the author points out that, while the sources of interest income are usually determined by the obligor's residence, occasionally the payor's source of income is determinative, but the source of dividends is determined solely by reference to the payor's source of income, with variations depending on the declaring corporation's place of incorporation. Thus, a dividend from a domestic corporation to a nonresident alien or foreign corporation will not be treated as coming from United States sources if less than 20% of the paying corporation's gross income has been derived from United States sources, while dividends paid by a foreign corporation are not considered to be from United States sources if less than 50% of its gross income was from sources within the United States. In the latter case, if more than 50% of the gross income was from United States sources, the entire income is not considered as being derived from sources within the United States, but a proration is made.

Following the discussion of interest and dividends, the sources of income arising from compensation for personal services, rents and royalties, and the sale of personal property are considered. It is in the discussion of the sources of income of this latter type—the sale of personal property—that this booklet reveals its strong and weak points. Its strength lies in its broad discussion of the various areas included under this concept, viz., the place of sale, the place of purchase, and the various methods of allocation provided in the Regulations. But its weakness is shown in its failure to point out the pitfalls that face the taxpayer under the present rules for determining place of sale. The recital of the rule is not difficult, the problem is how a nonresident alien or foreign corporation can so conduct its business as to be certain that its sales will be held to give rise to income from sources without the United States. Here the summary treatment of the problem may prove to be misleading and the difficulties inherent in the current interpretation of the law are unduly minimized.

Then follows a discussion of the sources of income not specified in Section 119—including partnership income and trust income —together with suggested methods of apportionment. The closing pages of this section

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contain an interesting summary of the types of income which the courts have included under the headings of interest, dividends, personal service, rents and royalties, and sales of personal property.

The purpose of the foregoing somewhat detailed analysis of the section of the book on "sources of income" is to illustrate the thoroughness of its coverage, a conclusion which is confirmed by an examination of other sections. The discussion, of the various tax treaties gives sufficient information about their purposes and general organization to make an examination of the treaties themselves much simpler.

In short, this is an excellent and well-documented monograph for a person who wishes a complete over-all view of the tax problems faced by a nonresident alien and a foreign corporation. It will stimulate thinking, supply valuable information and assist in suggesting research on specific problems.

PAUL D. SEGHERS
CHARLES L. SAVAGE

New York, N. Y.

**Report on Costing Investigation for the Ministry of Health**

(King Edward's Hospital Fund for London). PROBERTS PRINTERS LTD., London, England, 1952. Pages: 91; 6/— net (post free 7/—).

**Report of an Experiment in Hospital Costing**

(Nuffield Provincial Hospitals Trust). UNIVERSITY PRESS, Oxford, England, 1952. Pages: 235; 5s. (5s. 6d. post free).

In May, 1950, the Central Health Services Council of the Ministry of Health suggested that King Edward's Hospital Fund of London and the Nuffield Provincial Hospitals Trust investigate the best methods for installing accounting systems in British hospitals which would adequately reflect hospital costs. The foregoing reports, published on November 28, 1952, reflect the results of such surveys and the recommendations of the agencies.

Despite the fact that these investigations were conducted independently of each other, both reports agree that a uniform system of accounting with integrated medical and administrative statistics, as a basis for unit and departmental costs, is the ultimate goal for all hospitals. It is further explained that a costing system, separate from the financial system, is neither necessary nor desirable. Recognition is given to the fact that variations occur between different sizes of hospitals

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and hospitals rendering different types of service.

"Cost accounting does not by itself effect economies; it is an instrument that may help in the diagnosis of wastage or inefficiency and may indicate differences in standards of service by showing variation above or below a national or regional norm. It is therefore important to use a method which will give comparable results between hospital and hospital, group and group, and between one financial period and another. This should be possible when only departmental prime cost is considered and where there is uniformity in the basis of allocation and measurement of output." The system as installed must therefore be a guide for the hospital administration.

As added emphasis, King Edward's Hospital Fund reports, "we respectfully submit that had an adequate system of accounting been in use in the hospital when they were transferred to the Ministry of Health, it is conceivable that the existing rigid control by regulation would not have been imposed and that expenditure would not have arisen to its present height." The reader is undoubtedly familiar with the fact that all hospitals in Great Britain came under the Socialized Medicine Practice Law, and financial control of these institutions was assumed by the government. Undoubtedly, the rising cost of hospital and medical care was one of the underlying reasons for these investigations.

With respect to the reports *per se,* both recommend that a chart of accounts for direct expenses is established in three categories, i.e.,

1—Salaries and wages, by departments.
2—Supplies, by departments.
3—Other expenses, by departments.

Methods of allocating or distributing overhead expenses from the non-revenue producing departments (administration, dietary, housekeeping, laundry and operation of plant) are shown in great detail by means of definitive exhibits. The importance of establishing uniform bases for such apportionments, uniform units of costs, and uniform means of counting such units is thoroughly delineated in these texts. It is further pointed out that the efficiency of the accounting system can be measured by its cost related to the results it produces. It is recognized, however, that administrative control is not possible without a complete knowledge of departmental as well as unit costs.

The practitioner in the eleemosynary hospital field will recognize some of the formulae and theories as being in use at the United Hospital Fund in New York. However, the methods recommended in these texts advance

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a greater detail in apportionment of overhead expenses to measure the unit cost of service both with respect to in-patients and out-patients.

An interesting presentation is made of the need to integrate medical and administrative statistics in the proper application of cost analysis. For example, the medical record librarian will report patient days on a discharge basis while the administrative office will report these units of service on an actual basis. This comes about by reason of the fact that the medical statistics are computed upon the patients' discharge from the hospital while the accounting department's units are computed as such occur. Therefore, when an analysis is made for a particular period of time, care should be exercised that the proper set of units of service is used in the computation.

The controversial subject of depreciation in voluntary hospitals is also expounded in complete detail. The conclusion that depreciation should be considered as an element of expense, despite the fact that the hospital may have been constructed with donated funds, is well documented.

The importance of the hospital budget as to its preparation, use and control reflects an important element in these surveys. It is pointed out that when a budget merely reflects an estimated expenditure for a given period of time, and lays down limits which must not be exceeded, it is only an appropriation of funds on a deficit-financing basis and is not a budget. Where, however, a budget reflects the opinions of the various department heads, is approved by the management, and where emphasis is placed on the financing of the cost of patient care, rather than the financing of the hospital as an institution, the budget meets its true purpose. This is so, since the budget is treated as a dynamic guide rather than a static report. The flexible budget will be so arranged as to meet changing conditions both with respect to a rise or decline in the cost of raw materials and wages in a given period; or a rise or decline in the services rendered to patients.

These texts should prove of interest to hospital councils, fund-raising agencies, and all public accountants who service hospitals, both voluntary and proprietary. The data presented are clearly explained and will make an excellent addition to the reference library of the practitioner.

DAVID H. TARLOW

New York, N. Y.

# THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

*The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.*

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# Variety in the Concept of Income

*By* A. C. LITTLETON, C.P.A.

*This interesting paper traces the development of and changes in the concept of income over the centuries—in feudal times, the days of the great trading companies, the era of the industrial revolution, and the world of today.*

THERE must be a concept of income (or profit) bound up in the technology which we call accounting. This is true because the word accounting now carries the connotation of a technology resting on ancient Italian double-entry bookkeeping. And because the unique contribution of double entry (i.e., the integration of real and nominal accounts) was, and is, focused upon the computation of enterprise net income.

A. C. LITTLETON, Ph.D., C.P.A., is Professor (Emeritus) of Accountancy, University of Illinois, residing in Denver, Colorado. He is co-author of "Introduction to Corporate Accounting Standards", and has written extensively in the fields of accounting theory and history. Dr. Littleton is a member of the American Institute of Accountants and is a past president of the American Accounting Association and former Editor of *The Accounting Review*.

This paper is based on an address delivered before the Denver Chapter of the National Association of Cost Accountants on March 18, 1953.

Accounting was gradually perceived to be a systematic and widely useful method of classifying concrete money facts. But it needs to be emphasized that later adaptations of this methodology to uses wherein accountability rather than profit is the objective, do not change the fact that some concept of income is basic to this technology even under these circumstances. Adaptation meant that variety in the concept of income was inevitable, with attendant possibilities for confusion.

### Antecedents of Income Determination

In the sense of useful record-keeping, something akin to accounting was in use in England before double-entry was known there. On the landed estates of the sixteenth century very elaborate accountability records were kept by separate operating departments—farm, kitchen, bakery, etc. Internal check between departments was fully developed; expenditures were budgeted in advance; the resulting records were carefully summarized and annually audited. The summaries (financial statements?) were in the form we know as "charge and dis-

charge"—that is, reporting details which say: "I am accountable for—"; "I discharge my responsibility in these ways—". Clearly this was not an accounting calculation of net income.

Commercial profit was of course not unknown in seventeenth century England, but it was not calculated for equal time periods. This was the day of the great trading companys—East Indies Company, Hudson's Bay Company and others. The trading voyages of the East Indies Company, for example, were joint ventures. The contributing members divided the proceeds from the sale of goods brought back from foreign lands. Profit could be calculated by each partner from his own original costs and the final proceeds. This was profit in the true sense of the word rather than income. It was the result of liquidation; it measured the net of a closed venture, not a periodic calculation from continuing operations.

The calculations of accountability in the feudal estates were annual and the records were continuous, but the activities were not commercial. The calculations of an individual's profit upon liquidation of a trading venture were related to commerce, but were not based on continuing records. It was the Italians who, over many generations of evolution, succeeded in combining these two elements. Italian double-entry bookkeeping provided a continuing record of commercial transactions. This made it possible to make interim calculations of operating net income whenever desired. It does not change this characteristic of double-entry that the accounts were seldom closed annually. The merchant could see the accumulating results at will by looking into the main accounts in his ledger.

The third idea of income is found in Italian double-entry—that of a continuing, interrelated flow of revenue and expense associated with a continuing commercial enterprise under management. The records of the day included real accounts, particularly debts receivable and debts payable, and nominal accounts (goods, expense) that were closed into a profit and loss account and thence into capital accounts as at present. The origin of the balance sheet was a "balance account." Herein, particularly when the personnel of a partnership changed, were assembled by transfer entries, the balances of the several real accounts remaining open after all nominal accounts and the profit and loss account had been closed.

Several aspects of Italian double-entry should be noted because of their relevance to this third idea of income.

1. This method did not involve an appraisal calculation of net worth as of two different dates; it therefore did not reflect a concept of income as an appraised increment in property values. It used historical cost not for anyone's convenience but for the reason that cost represented money capital invested (risked) the measured money outcome of which, when compared with historical cost, would make it possible after the fact to judge the wisdom of having taken the prior investment risk.

2. The familiar sequence of entering transactions and closing the accounts was used from the fifteenth century. This sequence of methodology was closely related to the main contribution made by double-entry.

The primary contribution was not that of securing equality of debit and credit in journal entry or in the trial balance. It lay in the integration of real and nominal accounts. It is this "invention" that makes it more rational than convenient to record the same transaction fact in two categories. It is integration between the two major groups of accounts that causes the capital statement and the income statement to tie into each other. The larger significance of this tight interrelationship is clear when we note that here, for the first time, was a method for systematically and continuously recording the interaction of capital on income and of income on capital, thus making it possible to observe the separateness

and the interrelation of finance and operation. Obviously a very fundamental process had been devised. Its fundamentalness is more clearly visible now than at its beginning. For that early foundation still lies beneath modern accounting in a setting of complexity utterly inconceivable in an earlier day.

The next three hundred years showed little change in double-entry itself. This was the time of its slow spread throughout the world. Gradually, and ultimately completely, double-entry replaced accountability records (charge and discharge); and continuous (i.e., periodic) calculation of income replaced irregular calculations of the liquidation profit of terminable ventures.

## Early Concepts of Income and Profits

Late in the eighteenth century a direct statement was made in Adam Smith's *Wealth of Nations* to the effect that profit could arise only if "goods changed masters." This idea we now call the realization principle; it seems as reasonable under the new name as under the old phraseology. By inference both expressions include the idea that unrealized value change does not generate profit or loss. Before realization, price change only hints that profit or loss may eventually materialize. This inference, so plainly lodged in the British economist's phrase of 1776, gained support in the English courts in 1870 and again in 1894, in cases which ruled in essence that price rise and fall did not affect profit available for dividends.

Another idea, developed in the early days of British railroads, involved a concept of profit radically different from the one now associated with the use of historical cost and the amortization of fixed assets. The traditional British double-section balance sheet originated at this time. It was accompanied by a replacement doctrine about the way to account for fixed assets. That is to say, maintenance cost and replacement items were charged against revenues; periodic amortization of original investments in fixed assets was not used.

Several reasons might account for these practices. Possibly engineers held the opinion that wear was not currently measurable. To economists loss from wear would not be considered as currently realized since goods did not change masters. The idea that fixed assets represented capital permanently sunk in the enterprise, no doubt had a legalistic origin. By analogy a business enterprise would be considered similar to a landed estate. The law of estates and inheritances had long before established the concept of corpus and income—the one being the claim of the remainderman, the other measured the interest of the life tenant. In order to do justice to the basic intention of the testator, the corpus had to be maintained intact. As a consequence, income to the life tenant could only be an excess of estate revenue beyond the amount necessary for maintenance of the physical corpus. On this basis, with a railroad considered analogous to a trusteed estate, it would be reasonable to treat fixed assets as "capital permanently sunk" (corpus) which would be as useful as ever if parts were replaced as needed. Until replacement was necessary, enterprise revenue, still under the analogy to estates, would be available for dividends after deduction had been made for actual operating expenses. In other words, fixed assets would not be considered to create operating expense merely by being in existence and use.

In all probability enterprise management also had its reasons in support of the prevalent concept of enterprise income (i.e., income calculated by replacement accounting rather than amortization accounting). Amortization could easily have seemed highly artificial and unrelated to operating expenses. Not a few people are still inclined to lay considerable stress on

"out-of-pocket" expense and to look upon fixed asset cost amortization into expense as "mere bookkeeping." Furthermore, dividends for railroad stockholders were particularly hard to earn in the early days, even without amortization being treated as an expense long before replacement became necessary.

Such ideas could spell out justification of the then prevalent concept of cost and net income. Sometimes today the thought is advanced in the United States that the avoidance in England of the use of amortization of historical cost indicated a conscious intention in the accounting calculations to match current money prices for fixed asset expenses with revenue of similar purchasing power of the day. The idea could be an *ex post facto* rationalization of the known practice, since there is little in the literature of the time indicating that this kind of justification was then influential.

In view of the variety of concepts of income in Europe, it will not be surprising to find a variety in the United States as well.

Early in the nineteenth century corporations were chartered individually, each by a separate act of a state legislature. By the terms of some of these charters dividends were restricted to "clear profit", by others to "actual profit." Apparently these phrases would mean (1) profit clear of cost, expense, loss, or (2) profit actually realized, not mere anticipated profit.

Such meaning would still be quite understandable. Yet in 1825, when New York state passed the first general incorporation law, dividends were there limited to "surplus profit." Thus, a third idea was introduced, and as always variety made for confusion. Did the new phrase mean excess of gross income over cost and expense? Profit after deducting reserves and appropriations for retained earnings? Dividends out of retained prior earnings plus or minus current operating net? In what way was the new phrase better than the other two?

A century later the New York statute had dropped the noun "profit" and made the adjective "surplus" into a noun. Dividends were to be from "surplus." In retrospect, the change seems to have been ill-advised; and its reason for being is not clear. Is it significant that the change was made in the booming days of the 1920's, when revaluation of assets was of frequent occurrence? Did such appraisals produce a credit to "surplus?" Was the balance of surplus, thus increased, available for cash dividend? Was this new dividend base introduced into the law at this time by accidental coincidence?

It is not necessary to search for answers; possibly there are no answers. But whatever the reason for the terminology, it did not survive for a century as did the term "surplus profit." Before many years, lawyers and accountants each in their own way, showed that they favored limiting cash dividends unmistakably to "earned surplus." Thus, at long last in the 1930's, some of the variety of connotation lodged in the phrase "surplus profit" in the 1825 statute was to some extent clarified. The phraseology of the 1930's seems to intend to refer again to profit rather than surplus. By using the adjective "earned" it tells us (1) that appraisal credit is not included, (2) that both prior retained earnings and current net are available, and (3) that both the fruits of operating activities and the excess proceeds from sale of fixed assets are to be considered available for cash dividends.

Two points may be noted in connection with the last item above. It is in accord with the idea of taxable income expressed by statute and by the Supreme Court (income and gains from whatever source derived). Or perhaps it should be said, that the over-all concept of realized gain as income has always been the view typically held in all sections of American opinion. In contrast, it is characteristic of British opinion to treat capital gains as distinct from operating gains.

**Modern Concepts of Income**

Ideas about the concept of income are more sharply than ever under debate in America today because of the impact of a devalued currency and several years of sharply rising price levels. The issue concerns the choice between two ideas: (1) Income is the spread between historical cost and revenue from current sales; (2) income is the spread between current cost prices and revenue from current sales prices.

Only brief consideration of this issue can be given here. A few comments may be in order, however, in the setting here provided of variety and change of concept over a long period of time.

The question is at base one of the connotation of the word "realize." Realization was clearly a feature of Italian double-entry of the fifteenth century, since it made use of invested cost and not appraised valuations. It was also a feature of the thought in eighteenth century economics as shown by the phrase "goods must change masters." These ideas were generated by thinking about business enterprises. In later years, however, economic reasoning came to be focused strongly on the individual person, and today upon society as a very large group of individual persons. A person and a society do not "realize income"; personal and social "well-being" is the key-note. A typical leading question of today asks, "Can a person's money income measure his state of well-being?" Since his cost of living is a critical factor in his well-being, his money income is significant to the individual primarily in terms of its purchasing power. Social economists therefore are very much concerned with statistics which reflect the relationship between wage incomes and costs of living.

This interest is natural and understandable since men everywhere work in order to consume. And anyone desirous of improving the ratio of work to consumption will want to observe, and perhaps try to influence, that ratio. But thinking that is appropriate to an individual's well-being cannot be equally appropriate to a business enterprise. The analogy is not close enough to permit safe reasoning by analogy. The enterprise is an institution; it works to produce, not to consume. "Purchasing power" ratios are not there as significant as for individuals; purchasing is a relative small phase of productive enterprise. Since most of the property held is not kept for exchange, its value in terms of possible current selling price is not constantly an issue.

Because the enterprise is focused toward production, the chief question before its management is not whether physical capital is being maintained but whether the capital in hand is being effectively employed in production. Effective employment can only be judged after the fact. Hence it will always be necessary for those who decide to risk capital, in asset form or as cost or expense, to be able later to know the dollars previously invested (risked) in order to appraise the prior decisions when its fruits, in dollars, become known. "Purchasing power" accounting would not provide figures for prior invested costs that management could study. Management needs double-entry account data (historical cost) in order to make this backward appraisal of managerial decisions. If additional information is desired it should be supplemental, that is, provided outside the framework of historical cost double-entry.

The present debate therefore is one of concepts rather than of managerial objectives or record technology. Accounting has proved itself a very flexible instrument; it is able to incorporate a new methodology if the conceptual objectives are acceptable, that is, if new ideas do not negative the continuing usefulness of existing ideas and objectives.

There is good reason for believing that the spread between current replacement costs and current revenue is not net income to an enterprise. The reason is that realized price rise is one

of the inseparable elements of the measured results of effective enterprise management.

Income calculations guided by the presently generally accepted concepts are not unrealistic in fact or ideology. They may seem unrealistic however to one who does not know, or accept as rational, the basic ideas that underlie existing accounting methods. Perhaps that unwillingness to accept prevailing ideas as sound accounting may be due in part to a confusion of realism for an individual person and realism for a business enterprise under management. It could also be influenced by a belief that accounting, as a pliable dutiful servant, should make calculations as desired.

People who know the inside picture of accounting ideology and see aspects of a profession in all applications of accounting will not be easily influenced to reason about an enterprise as if it were an individual person or to accept a doctrine of subservience on the part of professional accountants.

The current debate on income concepts is clearly part of a continuing process of examining into the inner structure of accounting ideology that has been a long time in the building. Debate is a road to progress. And whatever the outcome presently, progress will result, if not at that time, then later when and if the facts of debate, after trial, have to be revised. It was made evident above that something like trial and reversal appeared in connection with the concept of a proper dividend base.

Variety of concepts we have had and still have. It would be well for us to keep this fact in mind because variety will persist, and persisting will constitute a continuing basis for misunderstanding. To the extent that we are able to appraise rationally and fully the significant differences between concepts, we will be better able to exercise good judgment as individuals and perhaps now and then help to clarify the thinking of others.

## AN ADIRONDACK VIEW

**Social Security** has become a most popular phrase in the English language and in English-speaking nations. It is getting so you can't make a good speech, write a good book, settle a labor dispute, or have a conference in the Adirondacks, without mentioning this ethereal something called social security.

CPAs, and other professional folks (as defined by law), are supposed to get it for themselves, and help pay to provide it for their grocers, druggists, clients and office staff. Meanwhile the C of L goes up, the household dollar goes down, and the heaven of social security has clouds in its fair skies.

But social security does exist. The folks in jail have it—they don't have to worry about where their next meal is coming from. Slaves have it—their job never goes out from under them. Our family dogs have it—food, shelter and medical care as long as they live.

Well, you figure it out, I can't. Patrick Henry had a different point of view.

Leonard Houghton, CPA
"Adirondack Chapter."

# Making Interim Audits Profitable in the Light of Increased Costs

*By* Sheldon S. Freedman, C.P.A.

*This paper points out methods of decreasing time on monthly audit engagements by increased efficiencies in the client's office, re-examination of the accountant's procedures, and curtailment of monthly financial statements.*

The certified public accountant has found it increasingly difficult, and in many cases impossible, to maintain his margin of profit. He has been pressed on one side by increased labor and office costs and on the other, by his inability to pass these costs on to his clients. There is an increasing realization among accountants that not only has a temporary ceiling been reached on the per diem or monthly fee charged, but in some cases, clients suffering financial reverses, are requesting decreases in fees.

This situation exists at a time when the accountant finds it necessary to increase the scope and extent of his services in most cases. He is called on not only to render financial advice, prepare budgets, find methods of decreasing overhead, and obtain necessary financing, but also must attempt to solve problems of salary stabilization, price control, and the ever-increasing complexity of the income tax law.

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This address was delivered by Mr. Freedman before the technical meeting of the Society held under the auspices of the Committee on Monthly Audits on December 11, 1952, at the Engineering Societies' Building in New York City.

What can the accountant do to solve his financial problems? Of course, there is no universal solution. However, the problem might be approached through the application of one or more of the following procedures:

1. We should attempt to make the client's office more efficient so that it produces more for the client and reduces the need for routine work on our part.

2. We should improve our auditing techniques and office and staff procedures.

3. We should consult the client concerning his requirements for financial statements.

## The Client's Office

Each situation must be approached in the light of the client's needs and the adequacies of the office staff. Generally, the approach should be one of cutting down routine so that the accountant may be able to spend more time on analysis and solution of problems.

The accountant should assume his rightful function of independent auditor rather than supplement the bookkeeping staff. Even today, many practitioners still insist on posting the general ledger themselves. Some feel that this is an important function, others wish to keep the client's affairs secret, and still others perform this work because the bookkeeper may be

unable to do so. Those accountants who do this bookkeeping work unnecessarily, are doing their client a disservice because the time spent can be put to greater advantage in the rendering of true professional services. To those who wish to keep their client's affairs a secret, it is suggested that a private ledger may be kept in a fraction of the time previously required.

In those cases where the bookkeeper is unable to do this work, a little patience and effort spent in instruction will save a great deal of time in the future. If the bookkeeper is still unable to do this work after instruction, I suggest that the difference in cost between a competent bookkeeper and an incompetent one is slight in today's market.

The client's staff should be required to keep a complete set of books and to prepare a trial balance and the necessary accounts receivable and payable schedules. The accounts receivable schedule should be aged at least quarterly, to enable quick analysis by the accountant. Payroll and sales tax returns should be prepared by the bookkeeper.

Time can be saved by the accountant if he can reduce the amount of adjusting entries required for the preparation of interim financial statements. In this connection the bookkeeper should be instructed to keep the purchase book open until the bulk of the applicable invoices have been entered, thereby reducing the need for summarizing long lists of unentered invoices. By the use of schedules prepared in advance by the accountant, the bookkeeper will have the necessary information to place depreciation and unexpired insurance and other adjustments on the books. Accruals for payroll taxes, payroll, and recurring expenses can also be made by the bookkeeper. These entries can be made, easily, through the medium of a journal for recurring entries. In this manner, financial statements can be prepared from the books of account with a minimum of further adjustment and at a savings in time.

The bookkeeping system should be reviewed by the accountant to eliminate unnecessary work and to install time-saving short cuts. These methods include one-writing payroll and accounts receivable posting systems, the use of duplicate accounts receivable statements as a cash receipts record, voucher register systems, and the elimination of the cash disbursements book by the use of a columnarized check book and the entering of all expenses in the voucher register. For larger clients, consideration should be given to the installation of bookkeeping machines.

The time saved by the introduction of these methods can be utilized by the accountant to obtain information of value to his client. Analysis of sales by product, by price line, by district, by units and by salesman may be obtained easily by the use of various sorting devices. Where possible, such as in the coal or fuel oil industry, statistics relating to tonnage or units of items purchased and sold can be prepared for the clients edification and as a basis for book inventory records. In factories, job cards might be used and summarized by the bookkeeper to give cost information not previously available to the client.

Your objection at this point may be that this increases the accountant's work. In its initial stages this may be so, but in the long run the increased efficiency of the client's staff will result in time-saving for the accountant. In addition, the client will be impressed by these evidences of the accountant's ingenuity and skill.

### The Accountant's Methods

Having done everything possible to improve the office methods of the client, the next step is for the accountant to improve his own auditing techniques and procedures.

In this connection, where over a period of time it has been discovered

that detailed vouching, footing and checking of extensions does not result in the discovery of material errors, the accountant should give consideration to the use of test-check procedures.

As to extensions, safeguards can be installed in the client's office whereby extensions of sales invoices and purchase invoices are checked by two different employees. For example, the test made by the accountant can then be limited to a few days' invoices or to all invoices of a larger amount.

In certain industries, where uniform prices are prevalent, analysis of the sales by units and price lines may be substituted for checking individual extensions. In order to make this possible, off-price sales might be separately stated. In addition to saving time, a valuable statistical figure is now available for any gross profit tests that the accountant may wish to make.

Footing is another time consuming auditing step, which may be decreased. Columns to be added in the various books of account can be changed from month to month on an irregular pattern so that the bookkeeper is unable to predetermine those which will be footed in subsequent audits. It may also be possible to elminate the footing of pennies and thereby achieve a time saving.

Vouching can also be limited or varied in different periods to invoices over a designated amount, or under a designated amount, or in other circumstances as in chain apparel stores, to coats or to dresses, etc.

The degree of sampling must be dependent upon the discretion of the auditors and upon the client's system of internal control. In this connection the auditor might eliminate completely, for one month, except for a cursory scrutiny, some specific auditing step, such as the vouching of purchase invoices. In that month, he would trace the client's procedures for the purchase of merchandise from the date the original order was given, to the time of receipt, through the various approvals of price and quantity and the final entry of the invoice on the books of account. Periodic examination in which specific functions are reviewed (for example, the time keeping for payroll and the eventual wage payments) will permit the accountant to determine whether the originally devised procedures have broken down through employee lapses or carelessness, or whether changes are necessary by reason of business growth or function. This consistent review of procedures is of greater value to the client than would be routine auditing procedures.

In setting up the auditor's work-papers, foresight can save time. For example, the use of large spread-sheets for insertion of monthly trial balances or the use of carbons to obtain an extra copy; or the use of a spread-sheet for recurring monthly journal entries, so that it is only necessary to insert new monthly figures.

Analyses of general ledger accounts can be set up so as to make it unnecessary to check general ledger postings or to check the previous month's total balance to ascertain that no changes have been made. This can be done by starting with previous balances per working papers, analyzing debits and credits, and the resulting balance must therefore agree with the new trial balance.

I have previously discussed the insertion of recurring entries on the books by the client's bookkeeper. Where this is impossible, time can be saved by the use of round figure estimates of depreciation, writeoffs of unexpired insurance premiums, etc., based on either the prior year's experience or upon the basis of a pre-computed writeoff. The small difference that may exist between these estimates and the actual amounts are not, usually, sufficiently material to warrant the time required for detailed computation.

### Financial Reports

In the actual preparation of financial statements, the time factor may be reduced by having six or more "dummy" reports typed at one time. In the actual insertion of the figures upon the report, it should be unnecessary, except in the most complex situations to post and extend a work sheet for the monthly report. The figures can be posted in short-money columns directly on the financial statements and totaled for final insertion in their proper places.

Consideration may be given to the elimination of monthly typed reports by using the many pre-printed forms available on the market wherein monthly figures can be inserted and a copy left at the client's office in a binder for ready reference and comparison.

One of the savings that may be achieved in typing interim reports of a voluminous nature is to eliminate pennies from the financial statements. A report of this type may be more readable and does not lose any of its significance. In some circumstances, books of account are being revised so that pennies are accounted for only in the cash, accounts receivable and liability accounts and in all other cases are charged to a penny clearance account.

### Staff Supervision

Savings may be achieved by closer supervision of the staff and by a re-alignment of duties. Re-examination of audit programs which have not been changed for many years may reveal steps which are now unnecessary or which may be curtailed. Staff-men should be encouraged to suggest changes which will improve the audit and eliminate unnecessary work. Of course, any changes should be approved by a supervisor before being put into effect.

It may be possible to decrease senior time on an assignment by turning over a larger portion of the audit program to assistants. In turn, junior time may be decreased by the use of comptometer operators for footings and extensions. In addition to the savings achieved by the use of comptometer operators who can do the mathematical work more rapidly, there is the efficiency obtained by the elimination of boring detail and the assignment of more responsible work to all members of the staff.

From the viewpoint of the staff, thought should be given to the heavy burden of work during the tax season. Longer hours and increasing pressure result in time-consuming errors and loss of efficiency. In this respect consideration should be given, wherever possible, to the adoption of the natural business year so that the work load may be spread throughout the year. In addition, pre-tax season planning may result in greater efficiency. For example, accounts payable and bank confirmations can be prepared before December 31st and mailed early in January. In this way, responses will be available when the audit is commenced and delays may be avoided. Pro-forma statements can also be prepared in advance and comparative figures inserted. This type of planning can obviate many overtime hours.

### The Client's Report Requirements

Another possibility for making interim audits more profitable, is to consult the client as to the possibility of eliminating monthly financial statements. Many clients may be in a business where expenses are fairly constant. Presuming a constant gross profit percentage, the client can determine his profit or loss position on the basis of the sales required to meet his fixed expenses. In this type of business, bi-monthly or quarterly statements may adequately serve his purpose. This is especially true, when the bookkeeper is able to provide interim figures from the books of ac-

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# Interim Statements on a True Accrual Basis

*By* Joseph Goldstein, C.P.A.

*The same care that is used in compiling all the necessary adjustments needed in the preparation of an annual report should be followed in interim statements. This paper discusses the possible distortion of net profit on interim reports as a result of excluding the more familiar types of expenses.*

The interim statement is an important guide to management and most essential to the credit man. Unfortunately, some of us fail to take into consideration vital adjustments in the preparation of this report and, as a result, the statement loses a great deal of significance and often may even be misleading to the individual who reads it. Picking up these adjustments at the close of the calendar or fiscal year does not eliminate the damage that may have been done during the interim period. Omitting them may result in considerable embarrassment to accountants.

To bring this out more clearly, let us consider the following situation: Towards the end of a year, a credit man telephones an accountant and requests his client's latest interim operating data. This information is given orally, by permission. Susequently, at the close of the year, the accountant prepares and submits his annual report.

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This paper was presented by him at a technical meeting of the Society held on December 11, 1952, at the Engineering Societies' Building, under the auspices of the Committee on Monthly Audits.

The credit man compares the interim and annual statements and finds that the net profit for the intervening period is unusually low, even though the volume of sales was high and the gross profit percentage had not changed. Seeking the reason for this apparent discrepancy, he finds that, on the annual statement, deduction has been taken for a substantial amount due an employee under a profit-sharing agreement and, also, for bonuses due officers. However, the interim report had made no provision for such expenses. The credit man is, to put it mildly, somewhat disturbed, because he had extended credit on a statement which did not show all the liabilities and he will probably convey these feelings to the accountant. Such an incident, which can be easily avoided, does not lead to good relationships between the accountant and the credit man. Conceivably, to borrow a Chinese phrase, the accountant might lose "face" before his client and the credit man.

In using the term "accrual basis," I have reference to adjustments involving both accruals and prepaid expenses. By excluding such adjustments, the net profit on the interim statement is incorrectly stated, as illustrated above.

The more familiar types of adjustments include the following expenses:

Vacation Payroll
Bonuses
Profit Sharing Agreements
Provision for New York City Taxes

Provision for Federal Income and Excess Profits Taxes
Provision for Bad Debts
Provision for Sales and Purchase Discounts
Insurance
Provision for Depreciation
Advertising
Percentage Rents
Interest
Professional Fees

These items usually cover an entire year's transactions and not merely the month or months during which they were paid or incurred. Therefore, in order to arrive at more correct interim operating results, we must distribute such expenses on a monthly basis. To illustrate: Although vacation payroll is payable during the summer months of the year, it would not be fair to charge only these few months with this expense. The more desirable method would be to include on each interim statement a proportionate share of the total annual vacation payroll.

An objection that might be presented is that too much time will be expended in assembling the data for all the adjustments, and, in view of the current high auditing costs and limited fees, the audit will be unprofitable. This may be readily overcome if we follow the suggestions made by Mr. Freedman, who has outlined in his paper numerous short-cuts and methods to be followed as well as ways of making greater use of the clients' employees for the purpose of supplying us with the necessary details. In addition, the basic information for most adjustments may be compiled during the first audit of the current year and can, with a minimum of time and effort, be used in all subsequent interim audits during that year.

Now, what are the most expeditious procedures for compiling the information needed to make the necessary adjusting entries? Let us consider each of the items that have been listed above:

*Vacation Payroll:* Many of us disregard this accrual on interim statements. Since virtually all companies have union employees, the first step should be an examination of all union contracts. In addition, we must look at the total vacation payroll of the previous year. We can thus arrive at the total estimated vacation payroll for the current year. In most cases, this has to be done only once, at the beginning of the year, and the necessary information will be available for all interim audits.

*Bonuses:* As an incentive, some companies give semi-annual or, more commonly, annual bonuses to employees and officers. These amounts might vary widely from year to year or might be virtually the same.

Even though bonuses are not considered liabilities until authorized by management, usually at the end of the year, nevertheless we should include a proportionate share of such expenses on interim statements in all instances where, in the past years, the company had paid bonuses. Otherwise, the results of operations for the intervening period between the latest interim report and the annual report would be distorted.

In order to arrive at the estimated amount that will be paid out during the current period, it is suggested that we determine the amounts paid during the previous three years. After arriving at an average, the matter should be discussed with the principals and adjustments should be made for any substantial, contemplated changes. The resulting amount should be allocated equally over the twelve-month period.

*Profit-Sharing Agreements:* In many instances, this expense is omitted from interim statements even though it has such an important effect on a company's net profit.

Since most of these agreements are in writing, their reading will yield all the facts needed for the accrual. The most vital section of any profit-sharing agreement is the definition of "net profit." The amount to be accrued may be computed by multiplying the percentage of profit, as stated in the agree-

ment, by the interim net profit determined in accordance with the terms of the agreement.

*Provision for New York City Taxes:* Some of you might say that, since these taxes are not too high, it is not necessary to include them until payment is made. If that practice is followed, the interim period, during which such tax is paid, will bear the brunt of an expense which does not apply solely to this period. For example, a General Business Tax payment of $1,000 would certainly be an outstanding item on the operating statement for the month of June. On the other hand, if the tax had been allocated monthly, the amount shown on the June statement would have been the proper fraction of the total expense.

The taxes that we are primarily concerned with in this group are: Real Estate Tax, Water and Sewer Taxes, and Gross Receipts or General Business Tax. Since water and sewer taxes are due not later than January 31st of any year, the payments will be treated as prepaid expenses. Real estate taxes will either be accrued expenses or deferred charges depending at what period of the year the adjustment is picked up. These taxes are paid usually in two installments (before October 31st and April 30th) and cover the period from July 1st to June 30th. Most of us, however, will wish to make provision for the General Business Tax. A quick method in arriving at this is to determine the effective rate on the previous year's tax return and multiply that by the sales for the interim period.

*Provision for Federal Income and Excess Profits Taxes:* Some of us submit operating statements showing "Net Profit for the Period, before Provision for Income Taxes." This results in a considerable distortion of the true net income. In addition, it is misleading to the client who has no conception of the tremendous impact of taxes on profits, unless the amount is specifically stated on the statement.

There are three possible approaches in arriving at the income tax liability on an interim statement:

1. To annualize the calculation in the manner provided for the computation of the tax when a return is filed for a short period.

2. To make the best possible estimate of what the probable profit will be for the entire year and then to calculate the tax thereon. The tax would then be prorated.

3. To calculate the tax on the profit earned within the short period upon the assumption that no further profit will be earned during the remainder of the fiscal year. By a footnote to the financial statement, indicate the rate of tax applicable to any additional profits earned.

In the "Current Accounting and Auditing Problems" section of the Journal of Accountancy for the month of October, 1951, Mr. Blough recommends method number two. He suggests that after the best possible estimate is made of the anual profit, the tax should be allocated to the interim period "in the ratio that profits during such period bear to the estimated annual profits." He further states that "this procedure is in accordance with practices that were generally followed during World War II and . . . it is in accordance with the practices of several of the well-known firms today."

*Provision for Bad Debts:* Too many accountants postpone the adjustment for bad debts until the end of the year. They fail to make provision for bad debts during the year as the accounts become uncollectible. This practice can be particularly dangerous currently because, as we all know, business failures have been on the increase.

Prior to audit date, the bookkeeper should be instructed to prepare an aged schedule of accounts receivable and to note thereon the bankrupt accounts and those that have been turned over for collection. The actual bad debts should be closed out to the Allowance account;

which should be increased by the amount written off. If the volume of business has increased substantially, it might be advisable to increase the Allowance account proportionately.

*Provision for Sales and Purchase Discounts:* Where the terms of sales or purchases specify discounts, adjustments for Allowances should be set up. If the terms of discount vary, it is necessary to examine the Cash Receipts and Cash Payments Books for the previous two or three months. Compare the total amounts in the Discount columns with the Accounts Receivable and Accounts Payable totals. Compute the average per cent of discount and use this percentage for your current period.

*Insurance:* In order to obtain accurate information for this accrual, we must check the client's insurance policies with the latest insurance schedule received from his broker. The monthly insurance cost can thus be easily ascertained, in most cases, by prorating the premiums. However, in the case of compensation insurance, where the amount cannot be determined until the expiration date of the policy, it is more advisable to multiply the monthly payroll by the rates listed.

Where the client's annual insurance payments do not vary much from year to year, the necessary monthly data are readily available by taking one-twelfth of the total paid.

*Provison for Depreciation:* An interim statement without a provision for depreciation is incomplete. However, some accountants still prepare such statements, even though very little effort is required to compile the necessary information.

The schedule used in the last annual report may be utilized for the interim statement. Care should be taken that no depreciation should be provided for any asset in excess of its cost. This can sometimes happen where an asset becomes fully depreciated during the current year. In addition, changes should be made in the depreciation rates if any are required as a result of an income tax examination. Obviously, any substantial depreciable asset acquired during the year should be added to the depreciation schedule previously computed.

*Advertising:* Large advertising outlays should be prorated over the estimated period that will benefit from these expenditures. For example, if your client has a radio advertising contract for "spot" broadcasts for a period of six months, the cost should be spread equally over the six-month period. If there is any pre-season advertising, it should be allocated during the period covered by such season.

*Percentage Rents:* Many retail establishments have leases which provide for rental payments computed as a percentage of annual sales. Each payment consists of a fixed minimum rent for the current month in addition to the overage due for the previous month. The difference between the minimum and percentage rent should be accrued on the interim statement. In doing this, we should also consider any rent ceiling stated in the lease.

*Interest:* This consists of two groups: Prepaid interest on notes discounted with banks, or other financial institutions and unpaid interest accruing on various obligations. The liability section and the interest payments must be carefully scrutinized and the total deferred or accrued interest allocated over the proper period.

*Professional Fees:* Year-end additional accounting fees may be treated as monthly expense items instead of as an extraordinary year-end expense. Annual legal retainer fees should be handled in the same manner.

* * *

I have attempted, in a very general way, to outline some of the possible adjustments that are not included on an interim statement. In analyzing these, you have probably come to the conclu-

sion that some are estimates. That is true. However, they are based on facts and not mere conjectures. For example, vacation payroll is an estimated accrual. Can you imagine what would happen to an operating statement for the months of July and August if the cost of vacations, which are normally paid for during these months, had not been allocated equally over the entire twelve-month period?

In summary, the preparation of interim reports on a true accrual basis will yield the following beneficial results:

1. Management will be currently supplied with more realistic and accurate information.
2. By also supplying the credit agencies with such data, your client will receive the maximum cooperation from them.
3. You will have more helpful information at your disposal in your attempt to minimize your client's tax burdens.

## Making Interim Audits Profitable in the Light of Increased Costs

(Continued from page 428)

count based upon an adjusted trial balance.

In other instances, such as a highly seasonal business where finished goods are manufactured for sale during the season, monthly figures are not a true indication of profit and loss. Financial statements prepared at the end of the season will give a more accurate portrayal of profit and of financial condition.

Each client presents a different problem and there can be no general statement as to the need for monthly financial statements. There is no doubt however that one of the most time-consuming portions of the small engagement is the preparation of the financial report. From this viewpoint, the client's needs must be examined in the light of the expense involved to him and the savings to be achieved by the accountant. In many cases the monthly report, however valuable, has become a luxury that the client is unwilling or unable to pay for. Under these circumstances, the accountant has no choice but to strive to eliminate it where the engagement is not profitable.

Elimination of monthly reports does not necessarily mean the curtailment of monthly audits. The accountant may desire to continue his present monthly visits so as to keep the client aware of his presence and advice. The client will then feel that there has been no major change and the accountant will still be able to reduce the amount of time spent on the engagement.

### Conclusion

Certified public accountants have always attempted to provide their clients with the highest caliber of professional service. Regardless of fee, we must continue to do so. Auditing standards cannot be sacrificed to make an engagement profitable. Efficiency and ingenuity, however, may permit the performance of a professional job within the confines of the present fee, despite the increased expenses.

# Monthly Audits and Reports

*By* Ernest D. Loewenwarter, C.P.A.

*This paper recommends a re-examination of monthly audit and report practices. It suggests modification of some time-worn practices and recommends some additions to the usual audit procedures. The author also takes into account the auditor's problems of manpower shortages and rising costs.*

Monthly audits and reports by independent accountants have become a necessary service for business management at certain levels. The monthly auditor and his reports are commonly regarded by the small or medium-sized concern as fulfilling the functions of an internal auditing staff and a systems and research department, as well as the functions of a controller in furnishing detailed reports which are vital in the areas of merchandising, production, selling, and financial matters.

It is the duty and responsibility of a practising accountant constantly to re-examine this service. He must consider its value to his clients, as well as its importance to himself. Advances in bookkeeping and accounting techniques and the use of modern office machines and time-saving devices necessitate a revision and streamlining of audit procedures, in order that the most effective service may be rendered and the most useful information may be presented in the auditor's reports.

At the same time, the auditor cannot ignore the constantly rising cost of staff salaries and incidental services and expenses, which make this type of work so costly for him and for his client. If he cannot make an adequate charge, there is no reward for his hard work and if the fee becomes too burdensome for the client, the service will be discontinued.


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This paper was presented at a monthly meeting of the Albany Chapter of the Society, on November 19, 1952.


We accountants must revise our monthly audit programs. Too often do we realize that we are following a routine of needless examination of detail. Some reflection upon the lack of productive results and the failure to disclose anything of importance should bring us to the realization that much of the detail may either be safely omitted or reduced to a test procedure. This will depend, of course, upon the accounting system employed by the client, the adequacy of the system of internal control, and the general circumstances and purposes of the audit engagement.

We find many monthly audits consist of adding the books, reconciling the bank account, checking the general ledger and, perhaps, submitting a trial balance. This is usually an inadequate service to the client and it is unimaginative and uninteresting for the auditor. The client derives little or no benefit from it; he has little respect for it, and he may rightfully refuse to pay for it on a professional level. It is frequently a discredit to the accountant and to his profession, and it certainly retards its growth in the public eye.

There is no justification for the accountant who fails to advise a client of his essential auditing needs and thereby accepts an assignment in which he

allows the client to rely upon the audit as adequate, when, in fact, some important phase of audit coverage has been omitted.

**Reduction of Detailed Checking Possible**

A monthly audit normally envisages a more comprehensive coverage than a less frequent audit or an audit undertaken for a different purpose. However, this does not always justify, for example, the monthly calculation and addition of duplicates of consecutively numbered sales invoices, which have been prepared on mechanical billing machines and checked in total against predetermined totals of original shipping tickets, which have already been precalculated. Yet we find many monthly audit programs that automatically include the monthly recalculation and addition of sales without thought of the needlessness of the process.

We have also seen situations in which a detailed audit of every cancelled check is unnecessary. It may be possible to eliminate this requirement where the auditor can be instrumental in influencing a change in the client's office procedure, which will accomplish control of checks drawn, by another internal process. We do not advocate abandoning the audit of checks in every case. However, in many concerns the largest number of checks drawn is in payment for merchandise purchased. Under these circumstances it may be possible to maintain a separate bank account for payment of merchandise bills only. Where the auditor in such a case vouches the purchase invoices and also audits the accounts payable control, it may be possible to limit the examination of these cancelled checks to a test. This will, in turn, depend upon a proper system of cancellation of purchase invoices as they are paid, to avoid double payments. It will also depend upon the degree of control that can be established through separation of the accounts payable and the check-writing responsibilities.

In the matter of payrolls, it often seems unnecessary, where employees are paid by check, for the monthly auditor to examine every cancelled payroll check. If the payroll record is properly audited and the amount of the total payroll is predetermined, and particularly when a separate payroll bank account is maintained, the only advantage in examining the payroll checks would be the inspection of the employees' endorsements. This is at best only prima facie evidence that the money has been received by the proper person. A proper audit of the payroll itself would seem to obviate the necessity of more than a test of the payroll checks, two or three times a year.

Similar consideration might be given to limiting the extent of the "vouching" of purchase invoices (the checking of these invoices and supporting documents against the corresponding purchase book or voucher register entries) under certain conditions. An audit of all invoices for other than merchandise may offer assurance that no invoices for merchandise were improperly recorded. The only other reason for an examinaton of invoices for merchandise would be to determine that the materials covered by the invoice had actually been received, and that the price and other particulars are in accord with the order given to the supplier. This phase of the auditor's responsibilities should be covered by a proper audit of the receiving records, either in their entirety or by test according to the circumstances and the system in use. It would certainly seem that this latter function would be more practical than a mere checking of invoices for merchandise against a column set aside in a purchase book or in a voucher register, for the entry of invoices of this class.

It is also often impractical to audit a mass of petty cash vouchers. We have found this to be true particularly in moderate size concerns where it

often seems, from a practical point of view, impossible to obtain the proper respect for and control of small expenditures. Frequently these vouchers are found to be imperfect from the standpoint that they are unsupported by satisfactory evidence of the payment, or they do not contain proper signed authorization. Where this condition exists, auditing the detail of meaningless vouchers accomplishes no purpose. The remedy lies in changing the system. If authorization is the responsibility of a person who can not or will not take the time to authorize petty cash disbursements, the authority should be vested in someone else. When proper authorization is assured, there may be even less justification for more than a test of such vouchers by the monthly auditor. The value of the test will lie in providing assurance that the process of authorization has been properly carried out.

In general, a study of the results and the effects to be obtained will usually provide a basis on which the monthly auditor may determine whether the time he spends in a prolonged detailed process is justified. His conclusion will be influenced in every case by the system and method of internal control existing in the client's organization. A better service will be rendered by bringing about changes in the system than by auditing an ineffective system.

### Suggested Reductions of Auditing Procedures

It is obviously impossible to discuss all monthly audit procedures and also all the situations and conditions under which those procedures should or should not be applied to a greater or lesser degree. It is suggested, however, that the following time-consuming processes be re-examined where they are part of a monthly audit program to determine their effectiveness and value under the circumstances and conditions of that particular audit.

*Additions:*

- Sales Records
- Special Cash Books (for Payrolls, Accounts Payable, etc.)
- Petty Cash Books
- Departmental and Branch Analyses
- Rental Records
- Trial Balances and Schedules
- Selection of Proper Columns to be Added

*Calculations:*

- Duplicate Sales Invoices
- Purchase Invoices
- Payrolls

*Vouching:*

- Sales Invoice Copies against Summaries
- Purchase Invoices against Merchandise Purchase Record (where there is no analysis)

*Reconciling Special Bank Accounts*

*Checking Postings:*

- Subsidiary Ledgers
- Departmental and Branch Ledgers
- Payroll Records

It is not contended that all of the foregoing procedures may be safely omitted from all or even from any particular monthly audit program, or that these are all of the procedures that should be re-examined for their value. In many cases these audit steps should be included on a test basis, monthly or at several intervals during the year.

### Suggested Additions to Auditing Procedures

It is contended, however, that where monthly audit time can be saved by the elimination of unnecessary and ineffective procedures, there are many substitutes which can make a monthly audit more effective and of greater benefit and value to the client.

These substitutes include the detailed or test examination of some of the underlying or supplementary records as well as special analyses and

studies, the results of which may frequently be included to advantage in monthly reports to the client. The inclusion of procedures of this type at least once each year will provide a complete coverage of almost every phase of the business in the course of a year. Some of the recommended procedures are the following:

- Check Sales Invoices against Shipping Tickets and Receipts
- Check Purchase Invoices against Receiving Records
- Check Work Tickets and Time Cards against Payrolls
- Prepare an Ageing of Customers' Accounts
- Audit Perpetual Inventory Records
- Preparing Analyses of Unit Sales and Unit Production
- Prepare Price Line Analyses
- Expense Analyses and Comparisons
- Percentage Studies
- Prepare Budgets and Comparisons
- Review the Systems and Procedures
- Make Cost Studies
- Prepare Statistical and Financial Charts

Upon examination of the foregoing recommendations it will be noted that they involve, in most cases, an examination of underlying records. Some of these records are frequently not included in the general category of "books of account." Nevertheless, they constitute the primary source of the data which are ultimately reflected on the books of account. It would seem meaningless for the monthly auditor to check the books of account without giving proper attention to the source material from which the accounting entries are made.

## Specialized Audit Procedures in Particular Industries

Specialized audit procedures may be adopted in particular industries to add value to the auditor's review of the client's records.

For example, in a wholesale bakery, inventories of flour may be verified by examination of truckmen's receipts and delivery sheets. The inventory may be further checked through the use of records of material consumed in the baking process.

In the case of a textile converter, yardage controls may be established to follow piece goods from the time of their purchase in the greige form through the next processes of dyeing and converting and ultimate shipment to the customer.

In the case of a trucking company, the variations in average daily costs should be examined and may be controlled through a record of gallons of gasoline consumed.

In the case of apartment houses and business buildings, rent rolls should be established and used as a basis for control of collections.

In an advertising agency, there is a control of all space purchased by using the standard 15% commission as a method of verifying income.

In a department store, the retail inventory method is used as a control of merchandise purchased and sold, and in a specialty store a unit control procedure is occasionally used. A wholesaler or purchaser of any commodity may establish a poundage control over a perpetual inventory system.

Control of payrolls in any business is of utmost importance. Efforts should be made to departmentalize the payroll, segregating regular and overtime wages, and thereby obtaining average payroll costs per hour or day by departments. A comparison of the number of employees or man-hours affords a means of reasonable check of payroll costs.

The basic idea in using these extra methods of check is to attempt to verify the accounting records by a check of some other source material.

## Tax Services

Of course, one of the most valuable services rendered by the monthly au-

ditor is in connection with federal, state and local taxes. In most cases, the strongest argument for a monthly audit lies in the fact that by continuous examination of the client's practices and transactions as they occur, the auditor is in a position to recommend treatment which provides the most favorable tax advantage. Where less frequent audits are made, the auditor is deprived of the opportunity to furnish the full value of this tax guidance.

A flexible monthly audit program which includes certain mandatory procedures and allows for the discretionary inclusion of others, such as those suggested, will result in a better service to the client. It will appeal to a prospective client as a worth-while service and after his retention it will afford the accountant an opportunity to apply his skills as a business advisor and consultant. It will reveal incentives and opportunities for specialized services which can provide additional rewards for constructive work well done.

It would seem that a great many of the foregoing recommendations would tend to increase the scope of a monthly audit program. It is, of course, not intended that all of the suggested procedures can, or should be, included either in every program or repeated in every consecutive monthly audit. The audit must be planned to meet the client's particular needs and the thoroughly accepted method of test may be applied either at regularly recurring intervals or at irregular times during the year.

## Monthly vs. Interim Audits

In the Midwest and, to an increasing degree, in many other localities, the character of this work is undergoing a change of still another kind. Both the high cost of salaries and the scarcity and rapid turnover of staff assistants have caused many firms to convert their practice from monthly audits to interim audits. We discussed this trend with one firm that devoted two years to making the conversion acceptable to their clients. They first made a concentrated study of each client's accounting procedures and internal controls for the purpose of avoiding the necessity of monthly audits.

They thereafter arranged for bookkeepers to prepare essential monthly reports. Pegboard and strip reporting devices were installed to facilitate the preparation of these statements in comparative form for use by the management.

The accountant thereafter contracted to make a minimum of four interim audits during the year, spaced at his own discretion, but having in mind the maximum advantage to the client. This took into account the seasonal character of his client's business, periods of maximum and minimum inventories, financial statement requirements, as well as closing dates.

The next step was to convert his clients, wherever possible, to the use of a natural business year and the accountant submits one report at the end of the fiscal year, this report being most complete with respect to the extent of his examination during the year and containing a complete analysis of the balance sheet and operating accounts. The report includes all of the significant ratios and some elaborate charts, which made the presentation of the fullest value to the client.

The client really looks forward to that report and, during the year, between the report dates, he uses the statements prepared by his bookkeeper. These statements are reviewed by the accountant during his interim audits and he furnishes such advice and consultation as may be pertinent to the results which these statements present. This interim work also includes tax advice and guidance.

The advantages to the accountant are obvious. He reaps all the benefits of scheduling his audits to meet his own timing and staff availability and thereby reduces the size of his staff. He

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# Financial Statements in Collective Bargaining

*By* Solomon Barkin

*It is the trade unionist's position that financial statements used in collective bargaining must be supplemented by special data permitting him to recalculate corporate income and the benefits and income of the entrepreneurs and employees according to his conventions and assumptions. Comparative financial experience permits him to make a more mature analysis of enterprise problems, while the break-even chart will facilitate discussion and illustrate the effect of different assumptions.*

## Minimum Use in Collective Bargaining

Because of the great materiality of a company's financial experience and resources to the discussions of union demands on employers, one might have expected financial reports to have played a central role in collective bargaining in this country. It might have been presumed that management would anxiously parade the financial facts in considerable detail before union representatives to help them realistically appraise the situation. Certainly such a procedure would have coincided with the declared objective of mature bargaining; namely, discussion on the basis of agreed-upon facts.

The experience has been otherwise. Managements have resisted giving unions information on their financial operations even when requested. Seldom have they offered data beyond that ordinarily available from published sources. The more prosperous the enterprise, the less interested has management been in releasing the detailed information to the bargaining representatives. Even employers facing difficulties have not been ready to offer data. The union has had to establish its rights through the National Labor Relations Board in cases where management has denied union requests because of financial condition.

Despite the minimum amounts of financial information actually exchanged around the bargaining table, the parties are generally aware of the size of the profits enjoyed by the enterprise and its economic and financial problems. Unions for their part have usually prepared themselves for these conferences with extensive information of an economic, industrial and financial nature. For the last category, its staffs would have assembled data from various sources such as public financial reports, the statements filed with the Securities and Exchange Commission and the Stock Exchange. Where the above are unrewarding, they will resort to financial services, investment houses, credit information agencies, summaries of industry-wide financial experience, and reports by the Bureau of Internal Revenue, the Securities and Exchange Commission and the Department of Commerce. The trade-union movement has always eyed most enviously the

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Wisconsin income tax law which opens tax reports in that state to study by interested parties. Individual unions have in recent years also bought a nominal number of shares in public corporations with which they are negotiating to insure receipt of annual reports, proxy statements and other company communications to stockholders. The newspapers carry many significant items of news concerning developments in corporations which help develop insights into the operations of individual corporations.

But the above information has not been carefully considered in most of the negotiations on the terms of labor contracts during recent years, as wage settlements tended to be well within the range of existing profit margins. Unions have therefore not had to supplement the company's financial reports with careful criticism of the degree to which the final net income figures understated actual returns. If such reports were issued, they were designed more for the education of the public than the needs of the collective bargaining sessions. Moreover, arbitrators and governmental control agencies guiding wage developments during the larger part of the last decade and one-half have uniformly minimized consideration of the company's ability to pay in the formulation of wage policy and in passing on the specific merits of union claims. They relied on price control, contract renegotiation and taxes to siphon off excess profits.

During this entire period the pressure for careful, reliable and valid financial reports has come primarily from investors, creditors and tax authorities with an occasional assist from the trade-union movement. The latter has endorsed the Frear bill to extend the numbers of corporations required to register with and report to the Securities and Exchange Commission.

Developments in our industrial structure reinforced the effects of general economic prosperity in minimizing the usefulness of the specific financial statement in collective bargaining. The public corporate enterprise has grown in size and industrial diversity during the last decade. The typical large business enterprise now consists of many plants scattered over many communities, states and regions. Their products are in different industries. The financial course of the enterprise is more intimately related to over-all national economic trends, than the specific economics of an individual product or market.

Collective bargaining has reflected this fact in that wage movements for American industry have followed the patterns set by several large corporations, which have agreed on similar formulae. The specific fate of an individual plant or sector of these mammoth organizations has not played a critical role in the determination of a wage and economic agreement. Nor have corporations themselves considered it desirable to isolate individual plants or differentiate among their components. The prospering divisions have carried the less profitable ones.

The over-all course of our economy has been more relevant to the negotiations than the specific economics of an individual product or the differentiated financial experience of a particular plant or enterprise. Deviations from national wage or benefit patterns have also tended to be uniform for specific segments of an industry or an area. Uniform wage adjustments and levels have been promoted for competitors, thereby assuring equal treatment. Individual companies or plants have therefore accommodated their operations to this framework and relied on their managerial skills and effectiveness to maintain their competitive position. Subsidies to the inefficient through lower wages and fringe benefits are becoming less common. The differential financial results of the individual company are therefore less material to the collective bargaining process.

If profit margins are considerably narrowed through intense competition

and irregular operations in the periods ahead, union demands will tend to be examined most closely and the financial statements will become more significant in bargaining sessions. We already have had such experiences in the case of the less fortunate branches, the consumers goods industries, which have not shared in the high activity and prosperity enjoyed by the economy as a whole. Individual companies or sectors of an industry have been hard-pressed. They have had to review their financial and cost structures most carefully and have learned that these facts must be shared with and reviewed by the union in order to find mutually acceptable answers. In such an era the financial statements become a critical document for consideration of the parties.

### Union Needs in Financial Statements

The financial statements are one starting point in the examination of a company's claim for its inability to meet union demands. Many other types of information are of course of interest, but the financial statement has the particular merit of providing a summary of business experience. But it is quite apparent that the general-purpose statements have limited usefulness for collective bargaining. They have been primarily prepared to inform the creditor about the company's earning power and its solvency and ability to meet its obligations. The investor is able to determine from it whether he is likely to be paid his dividends and is given many facts necessary for him to decide whether to invest or sell. Management is able, on the basis of these and supplementary statements, to select the items to produce. The government secures special statements to tax, set prices, renegotiate contracts or check on compliance with the laws. General purpose statements must be supplemented with special data for each particular interest.

These are the union's primary questions in reviewing financial information:

1. What were the business profits before and after taxes?
2. What financial benefits did the entrepreneurial interests, and the employees receive? What gains did the enterprise itself retain?
3. How does the company's financial experience compare with that of other enterprises?
4. What is the likely future business course in terms of volume of sales, prices and costs?
5. What are the present and likely future break-even points for the business?

### Corporation's Income

The first question which all groups are interested in having answered is the size of the profits. However this is not a simple procedure. The results of any calculation will necessarily depend upon the assumptions and procedures followed in organizing the information. Unions and employers are not likely always to be in agreement upon the individual accounting conventions. Many serious controversies have been raging among accountants and between business and government and economists as to the propriety of one or another accounting practice. Fundamentally these procedures, practices and theories reflect the businessman's own economic and social views and these are likely to differ from those possessed by other groups in the community, particularly the worker.

If we are to start from a sound basis there must be a supplementary statement outlining the principles and procedures followed in the preparation of the statement. At a minimum, the explanation should detail the rules followed in (1) recognizing revenue and expense for a specific period; (2) valuing inventory and cost of goods sold; (3) making depreciation charges; (4) handling deferred charges and intangible assets; and (5) dealing with non-

recurring charges or credits. There should also be a statement on other special practices and particularly on deviations from procedures and rules outlined by the Federal income tax procedure, the Bulletins of the American Institute of Accountants and the "Concepts and Standards Underlying Corporate Financial Statements," of the American Accounting Association.

It is also necessary to stress that a single net earnings figure will have as little significance in collective bargaining as it has for any other purposes. The current tendency to expand the items in the printed report and include in the latter document supplementary statements, is indicative of the need for such information. These additional data have become more common as management has attempted to promote its specific views on the modesty of its income. It has therefore added statements on the replacement costs of the current assets to highlight its belief in the conservatism of depreciation charges. Current accounting practice also dictates supplementary statements on unfunded pension obligations. For collective bargaining purposes other supplementary statements will be required.

In reviewing financial statements, a trade-unionist is likely to look askance on many current accounting practices. Fundamentally, he shall insist upon close adherence to an actual cost or income accounting. Any procedure which permits the accountant to modify or alter an entry, to adjust it to an outside cost or income figure will be looked upon suspiciously. It opens the accounts to manipulation and possible loss of integrity. The basic rule for the trade-unionist is that no figures should be substituted for values actually incurred. A business is interested in returns on money investments either in fixed assets or working capital. They are made in current monetary designations. Gains and losses are made in terms of these dollar values. Sales which net gains over actual costs are known as profits and those which net less than costs are losses. A business executive may wish to evaluate the financial results in terms of other current developments, but such appraisals must not be mistaken for an accounting of an actual transaction.

The above position will shape the unionist's attitudes respecting innovations in accounting procedure currently urged by management spokesmen. Necessarily he is likely to disapprove of the last-in-first-out method of inventory evaluation even though it has been approved by the Federal Bureau of Internal Revenue. It substitutes replacement costs of goods sold for actual costs. It may help smooth out income. But its ultimate result in our current era is to reduce the corporation's calculated income and thereby reduce profits. The unionist feels that adjustments should be effected and reserves set up through allocation of reserve or surplus accounts.

Again, as to the current proposals to revalue assets in terms of current prices for the calculation of depreciation charges, trade-unionists have been most critical. As a member of the "Study Group on Business Income" I disapproved of the recommendations, though I had no objection to management preparing supplementary statements reflecting its views.

This proposed accounting procedure is essentially inequitable and favors the owners of assets in large public corporations to the disadvantage of other groups in society, particularly persons holding financial assets or paying for services rendered or products made by these older capital goods. The unearned gains should not be captured by one economic group. Moreover, the gains and losses of every business transaction are real in a financial sense. Our community recognizes dollar values as real. Adjustments of these values for analytical purposes do not justify changing our form of financial reporting. Financial transactions are recorded in terms of current dollars.

Any such innovation would merely compound the confusion now prevailing in financial reporting which has made all wary. The accounting profession has not accepted these proposals for adjusting corporate business accounts to the changes in the price level.

Another proposal which will get little if any trade-union support is that of allowing the management to select its own period and method of allocating depreciation charges on equipment. It is urged that this procedure will stimulate the purchase of new capital equipment without an ultimate loss of revenue. But the immediate loss of revenue may be so huge that the federal government will not be able to afford such a procedure. Nor is the adoption of the proposed formulae associated with any guarantee of the purchase of new equipment. The proposal would accentuate a trend already strongly present in our society for the self-financing of expansion by larger organizations. The result would be to shift the tax burden from the corporation to the individual without a compensating reduction in prices.

Another section of the financial statement which trade-unionists examine most closely is the assignment of costs to repairs and maintenance. During periods of physical expansion or modernization of equipment, many costs are charged to current expense which may be more properly capitalized. While the significance of this item may vary, its total amount is most significant and may in individual concerns seriously affect the final income figure. The Bureau of Internal Revenue reports the total amount charged by corporations to repairs in 1949 as $3½ billion.

Among the current accounting and business practices called into question by the trade-unionists is the inclination of business enterprises to increase their donations and contributions to charitable and other philanthropic causes. No union is against such gifts, but they are not appropriate charges on the cost of production. If they are to be granted they should be deductions from surplus. No worker wants his increase in wages to be held back because the management wants to be generous to an outside cause or to build up its prestige and control of public and community agencies. These contributions are increasing business control over our public institutions and in some instances they have been used in the conflict situations against trade-unions. Moreover, these contributions are substantially reducing corporation tax payments and thereby shifting the tax burden onto individual income.

The determination of a corporation's profit is affected by these and other accounting practices on which there will be differences between trade-unionists and the business community. To the extent that they exist, they produce varying evaluations of the corporation's statements, claims and position. The trade-unionist would prefer being able to recalculate the corporation's statement according to his views. It is for this reason, that it would petition for detailed supplementary statements necessary for such recalculations. The presentation of these differing statements can properly define the magnitude of their differences and thereby assist the parties in accommodating their views.

### Income and Benefits of Entrepreneurs and Employees

In examining the distribution of the income of an enterprise, the trade-unionist may distinguish three separate groups: the entrepreneurial, the employee and the enterprise. He is particularly interested in determining his income as compared with that of the other groups, but the modern systems of accounting are not set up for easy determination of these facts. Many items of group income such as interest or management's salaries, or workers' wages are included as costs. It is most important that business accountants study the union's interests in this area most closely so that they reassemble

their data for this special type of accounting.

The first major beneficiary is the entrepreneurial group. It embraces the owner-operator interests. In our complicated corporate world, these functions have been specialized and distributed among many persons, but the group is distinctive. Its members represent the property and managerial claims on the enterprise. It may be conveniently divided into four segments: the investor; the creditor; the manager; and the director. Their total income and benefits comprise entrepreneurial income.

To determine their income and benefits, a special supplementary analysis will be necessary. As for the investor, his income and benefits are clearly defined as dividends and capital gains. The second group, including creditors and bondholders, receive their benefits primarily in the form of interest payments and rights to other benefits. The management of course receives its compensation in the form of salaries, bonuses, stock options, and a miscellaneous list of other awards in the form of expense allowances, life insurance, medical benefits, home facilities, discount privileges, educational advantages and delayed compensation. The directors also are rewarded through fees and other privileges.

A significant factor in the calculation of entrepreneurial income is the less obvious benefits obtained through control or direction or association with the enterprise. Some individuals control several "independent" corporations and shift income from one to another through a series of so-called arm's length relationships which minimize taxes. The income diverted to these other businesses must be consolidated with the enterprise for true evaluation of benefits. The same problem arises in connection with the unconsolidated corporations of a larger business enterprise. While they are legally separate, their earnings and the rewards to the entrepreneurial group must be included in the final calculations. Similarly, one must consider and find a way of integrating into this allocation all income received by directors, management or investors through their association with the particular enterprise. Frequently, service with a business is largely rewarded by contracts, business opportunities and advantages in bidding. While the money value may be difficult to assign, they are distinct benefits.

The sum total of all of these benefits must be considered as one.

The second major group consists of employees. These are composed of supervision and professional personnel and the many component groups among the production workers. Their proper division is dependent upon the particular bargaining units developed for a given enterprise. The record of the income and benefits for each group separately, and all groups together, would be of special value. The income received by each person is clearly disclosed in the accounts as they are definite costs to the enterprise and can therefore be tabulated.

Unfortunately for present purposes, accounting systems are not always set up for the above separate calculation, as payments to employees may be scattered over diverse accounts. Records have not been established to ascertain income and benefits received by individual groups of employees. It is a method of accounting not yet firmly established but essential to deriving facts for collective bargaining.

The third beneficiary group is the enterprise itself. It is essential to determine at the end of each period the gains secured by the enterprise, either through expenditures or increased financial resources. How much had been spent for the enterprise? How much remains in liquid form available for working capital and future use?

The above types of analysis must become a permanent part of current accounting systems to make these facts available to the parties for collective bargaining. They will require many

technical innovations. Many questions not previously faced in accounting will arise, but they have to be answered and the conventions and practices most likely to serve must be developed.

**Comparative Financial Experience**

Detailed analysis of the finances of a specific company almost inevitably leads to interest in comparative business experience. If an individual enterprise desires to deviate from a prevailing pattern or the leader in an industry presses for a smaller wage increase than is common throughout the economy, consideration is immediately focused on the special reasons for the relatively less favorable fortunes. Unions will therefore promptly weigh the peculiarities of the enterprise or group of enterprises.

While the financial reports can seldom provide the full insight, they can serve as a fruitful basis for interesting analysis. They are likely to focus on comparative level of sales, cost of manufacture, products, management policies, investment practices, merchandising programs, advertising policies, designing problems, management overhead, expenditures, competency, and the host of other aspects of an individual business.

As individual companies present these challenges to unions, they are likely to be faced with inquisitive persons eager to get at the root of the troubles and comparatively unfavorable experience. They are prepared to bring in their own experts to help formulate their program and alternative suggestions to the management. Differential treatment on wages or fringe benefits is not the accepted method of meeting the peculiar problems of enterprise. Management must expect the trade-union to insist that the first remedy be improvements in management's own performance. The financial statement will be the starting point for this task and employers must be ready to unfold the pertinent facts.

**Forecast of Future Business Trends**

No financial statement is sufficient unto itself to determine the appropriate course of action or policy even with respect to wage policy. The experience for one period may be atypical. In specific industries with many intermediate steps in the process of distribution between the producer and the consumer, with opportunities for inventory accumulation or depletion at each stage, a regular short-term business cycle is common. No period can be appraised independently of this cycle. Long-term trends affecting product and process must be evaluated to make mature judgments. Supplementary judgments on general business conditions, raw material and other costs; product, prices, future economies, opportunities for innovation are material to and will be considered in arriving at any final judgments. Obviously the more formally these forecasts are made and recorded, the easier is it for the bargaining parties to consider them and to assess their validity.

**Break-Even Points**

A summary of the analysis of the financial experience and the projections can be presented through the break-even point chart. Such techniques have been advanced for other purposes. It is particularly useful in graphically outlining past experience and illustrating the impact of various projections and forecasts and the influence of such factors as level of operations, economies of operation, changing prices and developments in particular market areas. Through this analytical tool the differences in views can be carefully expressed and the accommodation of interests thereby facilitated.

**Conclusion**

Financial statements have played a minor role in collective bargaining in a period when profits were impressive, companies were expanding, or the cost

of wage and fringe settlements was passed on to the consumer. The negotiations were carried on in the full knowledge of the prevailing economic circumstances. Neither management nor unions was pressed to examine financial experience closely. During this era unions eyed the corporate reports most suspiciously. Periodically they announced their criticism of specific current practices. They have been particularly vocal on proposed innovations in accounting procedure and have opposed suggestions for adjusting real costs and income to meet replacement costs or reducing net income by other accounting techniques designed to lower corporate tax burdens. In specific proceedings before public bodies or in the case of public controversy over labor demands, unions have offered more detailed criticism of financial statements. However, the over-all inclination of public authorities and representatives to avoid detailed analysis has also restrained labor's studies of these materials. Nevertheless, interest has continued.

As management makes greater use of financial statements to justify its positions in collective bargaining, more attention will be focused upon them. As presently prepared, they are inadequate for collective bargaining purposes. They must be supplemented with data which will answer the questions raised in collective bargaining and enable the trade-unionist to make such recalculations of the business experience as he might find necessary.

The accountant can preserve his professional function by applying his skills toward developing systems of accounts serving these needs as he has developed them for the other groups, such as the creditor, investor, manager and corporation director. The article outlines the specific accounting information required for collective bargaining.

## Monthly Audits and Reports

(Continued from page 438)

reduces his report preparation to one a year instead of twelve. He correspondingly reduces his report typing costs as well as his consumption of stationery and incidental supplies. He usually can obtain the same, or even a greater audit fee for this service which has become accepted as a substitute for and, in many cases, as an improvement over his monthly audit and report work.

This paper is intended to cover, not only the subject of "monthly audits", but also "monthly reports." It would seem that the audit subject is sufficient in itself, to warrant the more intensive coverage and therefore we will leave a detailed discussion of monthly audit reports for another occasion.

However, it should be said, in passing, that, where the auditor submits a report, based on a monthly audit, that report must be an accurate one if the accountant is properly to fulfill his professional responsibility. Every effort must be exerted to present statements which include all ascertainable assets and liabilities, as well as income and expense items, with due regard for accruals and deferrals at the close of each monthly period. The auditor must be certain to conform with the requirements of Auditing Procedure Statement #23 of the American Institute of Accountants. He should make an adequate statement of the limitations which usually prevail in the case of a monthly audit and he must make it clear that his report is therefore not intended to be an expression of an opinion concerning his client's financial position or operating results.

# Some Notes on Accounting Research Bulletin 29—Inventory Pricing

*By* JOSEPH A. MAURIELLO, C.P.A.

*This article points out the need for further clarification on Statement 6 of ARB 29, as well as for the correction of certain inaccurate implications arising from it.*

IN July, 1947, the Committee on Accounting Procedure of the American Institute of Accountants issued Accounting Research Bulletin 29 entitled "Inventory Pricing." This bulletin was intended to clarify the long existing rule of cost or market, whichever is lower. It sought to show how market was to be measured and how the rule was to be applied under varying circumstances. It also pointed out areas in which inventories could be valued in excess of cost.

The bulletin consists of ten statements. Each statement is elaborated on and clarified in a "Discussion" section, which immediately follows the statement. The statements of widest application and, therefore, of greatest significance to accountants are statements 5 and 6. Statement 5 points out the reasons for deviating from valuation at cost when the "utility value" or "market value" of the inventory is lower. Statement 6 seeks to refine the measurement of market so that the inventory will be stated at neither more nor less than market.

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This article posits for consideration the need for (1) further clarification of statement 6 if it is to be applied meaningfully and uniformly by accountants, and (2) correction of certain inaccurate implications of statement 6.

### Recognition of Inventory Losses under Statement 5

Statement 6 can be appreciated best by reference to Statement 5, set forth below:

> "A departure from the cost basis of pricing the inventory is required when the usefulness of the goods is no longer as great as its cost. Where there is evidence that the utility of goods in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, change in price levels, or other causes, the difference should be recognized as a loss of the current period. This is generally accomplished by stating such goods at a lower level commonly designated as 'market.'"

The discussion section pertaining to Statement 5 stresses two points. The first is that cost is not the amount properly chargeable against the revenues of future periods if the utility of the goods has diminished since their acquisition. The second is that a loss in utility,

whether caused by damage, deterioration, obsolescence, or change in price level, should be charged against the revenues of the period in which it occurs. The pricing of inventories at cost or market, whichever is lower, is sanctioned as "a practical means of measuring utility, and thereby determining the amount of the loss to be recognized and accounted for in the current period."

Except for the fact that the term "market" is confusing, Statement 5 invites no quarrel. Professor Paton, as a member of the committee, opposed retention of the term "market" in accounting literature. A more precise term, in the opinion of the writer, is "cash realizable value." Use of the phrase cash realizable value recognizes that current assets other than cash and prepaid expenses are intended to be converted into cash, and, therefore, that the significant measure of value for such assets is the cash amount which will replace them. The committee repeatedly uses the term "utility of the goods." Since the goods in the inventory are to be converted into cash, the utility of the goods is necessarily measured in terms of their cash realizable amount. Accordingly, the term "cash realizable value" could logically supersede the word "market" and the phrase "utility of the goods." There would then remain the problem as to how to measure the cash realizable value.

### Measurement of Cash Realizable Value under Statement 6

This problem is the province of Statement 6, which reads as follows:

> "As used in the phrase 'lower of cost or market,' the term 'market' means current replacement cost (by purchase or by reproduction, as the case may be) except that:
>
> (1) Market *should not exceed* the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal) and
>
> (2) Market *should not be less than* net realizable value reduced by an allowance for an approximately normal profit margin."

The Committee points out that Statement 6 is intended "as a guide rather than a literal rule." Yet, even as a guide, clarification is required of the term "costs of disposal" in the first part of the statement, and the term "approximately normal profit margin" in the second part of the statement. Nowhere in the bulletin are these terms defined.

In the case of goods to be sold rapidly in unusually large lots, it would seem that the phrase "costs of disposal" implies merely the direct costs of making such sales and delivering the goods. On the other hand, if the goods are to be sold in normal quantities at the usual rate of turnover, the term "costs of disposal" should embrace an allocable share of total selling and administrative expenses, and not merely such expenses as are directly related to and flow from the specific sales consummated.

The phrase "approximately normal profit margin" would seem to refer to the profit margin experienced in the more recent part of the current fiscal period, assuming that there were no windfall gains or non-recurring declines which would invalidate such time-segment. The profit margin of the recent past provides the point of departure needed to measure the loss in utility or cash realizable value sustained in the current period on the goods as yet unsold. The shrinkage in this recent profit margin is the measure of loss applicable to the current period. This shrinkage is recognized in the only accounting manner possible—by reducing the inventory value.

### Inaccurate Implications of Statement 6

Finally, we may question the implications of the upper and lower limiting

values for market set forth in Statement 6. Let us consider the following three conditions applicable to finished product:

| | *1* | *2* | *3* |
|---|---|---|---|
| a. Sales Price | $100 | $.98 | $.98 |
| b. Disposal Costs | .25 | .25 | .25 |
| c. Normal Net Profit | .15 | .15 | .15 |
| 1. Cost | .60 | .60 | .60 |
| 2. Replacement Cost | .57 | .57 | .59 |
| 3. Net Realizable Value (a-b) | .75 | .73 | .73 |
| 4. Net Realizable Value Less Normal Profit [a-(b+c)] | .60 | .58 | .58 |
| Value under AIA Rules: Value is replacement cost (item 2) so long as not more than net realizable value (item 3) nor less than net realizable value reduced by normal profit (item 4) | .60 | .58 | .59 |

Conditions 2 and 3 are the same in all respects except for the replacement cost. In condition 2 the replacement cost is 57¢ and in condition 3, 59¢. The inventory values resulting under the rules of statement 6 for conditions 2 and 3 are 58¢ and 59¢, respectively. Objection, however, can be readily raised to the use of the replacement cost amount of 59¢ for condition 3. In theory, the cost to replace has no relevance in valuing goods already purchased. The goods on hand are to be sold; furthermore, they are to be sold in the ordinary course of operations to regular customers. Accordingly, the value of the goods must be measured in relation to the price that will be obtained from customers in the usual course of sales operations. This price is the net realizable value less normal profit. This cash realizable value is measured by the amount which total sales price reserves for product, as distinguished from the amounts which it reserves for services and supplies (i.e., selling, and administrative expenses) and profit. The amount reserved for product in the case of normal goods is the residual value remaining after deducting from total sales price all components except product. Statement 6 refers to this residual amount as the net realizable value (i.e., estimated selling price less costs of completion and disposal) less normal profit. Accordingly, the word "market" as used by the Committee should mean in *all* cases of normal goods the net realizable value less normal profit. It is proposed here that the rule of lower of cost or market, in the case of normal goods, means the lower of cost or net realizable value less normal profit. For condition 3, the inventory value is 58¢—the same amount applicable to condition 2.

### Replacement Cost an Improper Measure of Cash Realizable Value

It might be contended that the cost to replace is pertinent in inventory valuation where the enterprise is in a distress condition, and is therefore compelled either to return the goods to the supplier or to sell to a competitor. These are suppositions which do not generally conform to the facts of practice. Suppliers are loathe to accept returns of goods unless the right to return is stated in the original purchase contract. Competitors will usually not pay the enterprise the replacement cost of the goods. The competitor is aware that the enterprise is in a distress con-

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# Of Reading

*By* THOMAS W. BYRNES, C.P.A.

IN the overcrowded schedule upon which most CPAs operate today, it may seem difficult to plan a course of reading outside the field of bread-winning endeavors. And yet, if one is to keep abreast of the times and in step with the rest of the community, it is necessary to develop an objective program.

Gibbon in his Memoirs wrote: "My early and invincible love of reading, * * * I would not exchange for the treasures of India." This sentiment is shared by the present scribbler who formed the habit in the gas-lit era of the not-so-gay early Nineties.

Observation has shown that many CPAs limit their reading to accounting publications, supplementing these, for diversion, with occasional short-shorts or condensations of best-seller novels appearing in the weekly and digest magazines. These busy folks are not embarrassed if they do not know the answers when Junior asks the meaning of the Pentateuch or the Apocalypse, the first name or the claim to fame of Micawber, or any other question concerning famous literary works. Specialization in reading, due to the desire to be well posted on what is affecting one's immediate activity, is commendable, but too close application to its literature may result in narrowness of vision. Also, in social contacts, conversation, if confined to business topics can, in a mixed company, become bore-some. On the other hand, there are in every profession those who consider student days ended when success has been achieved in the State examinations. If an unusual situation arises, such persons have recourse to their old text-books, or seek the solution from an informed colleague or the State Society. This may be a brain-and-eyes-saving artifice, but it is neither shrewd nor smart; clients and patients soon become aware of their advisor's mental indolence.

A consummation devoutly to be wished would be for CPAs to merit that part of the description of Cassius in which Caesar said: "He reads much; he is a great observer, and he looks quite through the deeds of men." An attempt to free accounting practitioners from consideration as figure persons only, is shown in the April, 1953, Journal of Accountancy (page 475) by excerpts from a report of Mr. Winston Brooke, CPA, on a successful plan adopted in his office for wider reading by staff members. The aims are to broaden their education along cultural lines, to expand vocabularies, to avoid grammatical errors, and to increase ability to carry on an intelligent conversation outside the field of accounting.

In planning a reading program, it may be helpful to note the thoughts of famous readers and writers on the subject. In The Tatler, Addison wrote: "Reading is to the mind, what exercise is to the body. As by the one, health is preserved, strengthened, and invigorated; by the other, virtue (which is the health of the mind) is kept alive, cherished, and confirmed." Samuel Johnson felt: "A man ought to read just as inclination leads him; for what he reads as a task will do him little good." Bulwer Lytton said: "In science, read, by preference the newest works; in literature, the oldest. The classics are always modern." Carlyle's thought was: "The true University of these days is a collection of Books."

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And, from Francis Bacon: "Some books are to be tasted, others to be swallowed, and some few to be chewed and digested."

For summaries of the world's belles-lettres from which selections may be made, this writer suggests "The Outline of Literature" edited by John Drinkwater, with about 500 illustrations of which many are in color, a splendid work in three volumes on smooth paper and excellent print. It was published in 1923 by G. P. Putnam's Sons. Another summary, condensed in one volume (1054 pages) is "The Concise Cambridge History of English Literature" by George Sampson, published in 1946 by Macmillan.

A broad reading program which includes a liberal infusion of the classics from Homer on, will, if persisted in, return dividends not only in enjoyment and instruction, but also in the prestige gained through improved oral and written presentation of thoughts. The end result should be the attainment of Francis Bacon's maxim that "Reading maketh a full man."

## Some Notes on A.R.B. #29—Inventory Pricing

(Continued from page 449)

dition, and, furthermore, he is able to purchase the goods from suppliers at replacement cost. Accordingly, he will take advantage of his superior bargaining power by offering the enterprise a price below the replacement cost. In this connection, it should be noted, that it is more logical for the enterprise to mark down the sales price to be received from customers than to dispose of the goods at cost or at a lower replacement cost. So long as the sales price to customers exceeds product cost plus variable selling and administrative expenses, a margin is available to contribute to fixed selling and administrative expenses and possibly also to profit. Normal sales price generally exceeds product cost plus variable expenses by a margin ranging from 20% to 30%. Accordingly, the enterprise can reduce sales price just short of these percentages and still leave the margin referred to.

Where total sales price declines below cost or replacement cost because of deterioration, obsolescence, price war, or other abnormality, the measure of cash realizable value is simply the selling price less costs of disposal, i.e., the net realizable value in Statement 6. There is no deduction of normal profit from sales price since the abnormally low price does not provide for normal profit.

This analysis suggests two measures of cash realizable value for inventories:

1. For normal goods—Net realizable value less normal profit.
2. For abnormal goods or for abnormally low-price situations—Net realizable value.

### Proposed Rule of Inventory Valuation

From these observations stems the following rule of inventory valuation:

> Value goods at the lower of cost or cash realizable value. The cash realizable value for normal goods is estimated sales price less (a) costs of completion and disposal and (b) normal profit. The cash realizable value for abnormal goods or abnormally low-priced goods is estimated sales price less costs of completion and disposal.

This rule is applicable to all situations except those in which it is proper to value in excess of cost.

Replacement cost, it is repeated, in theory has no relevance in inventory pricing. Its use is justified only where net realizable value or net realizable value less normal profit involves too many subjective elements and assumptions in their determination. In these cases, the use of a replacement cost is warranted by practicality and expediency.

# Executive Stock Options in Financial Reports

*A Critique of SEC and Accounting Practices*

*By* J. H. Landman

Corporations frequently offer options to employees to enable the latter to acquire stock at reduced prices. The prompting motives are usually to give employees a proprietary interest, to retain dissatisfied executives, to attract new key help, and to acquire new capital. Tax-wise, executive stock options are compensatory, proprietary or restricted.

If they are compensatory in nature, the grant of the option is ignored for tax purposes but the differential between the option and market prices of the stock at the time of *exercise* of the option is deductible for the employer and additional income for the employee. In addition, the latter's tax value of his acquired stock is increased by this spread.

If the option is proprietary, its grant and the aforementioned spread are disregarded by the employer and employee, and the bargain option price is the basis for the stock in the hands of the employee for future disposition.

On the other hand, in the case of properly qualified restricted stock options, the employer is never entitled to a deduction with respect to the stock transferred to the employee, and the employee receives no income at the time of the option grant or of its exercise. However, if the employee holds the acquired stock until at least two years after he received the option and for at least six months after he acquired such stock, part of the profit from its disposition may be taxed as compensation if the option price was at least 85% and less than 95% of the market price of the stock at the time of the grant, measured by the lesser of the two market values at the times of the option grant and the stock disposal. The compensatory factor is consequently tacked on to the option price of the stock for future disposition. If the employee's option price is within 5% of market value he enjoys capital gains.

In the case of compensatory stock options, there are at least five likely dates when consequential employer-employee tax accruals might occur: (1) corporate adoption of the plan, (2) employee qualification, (3) grant of the option, (4) exercise of the option, and (5) disposal of the stock.

Nevertheless, the Federal Securities and Exchange Commission (SEC) has been of the opinion that in the interests of the investing public corporate financial statements must reflect a deduction for compensatory stock options when employees become qualified for them in an amount equal to their fair market value. The corporations concerned have been protesting this practice because it renders their financial statements unrealistic for the years involved, but have reluctantly yielded. The American Institute of Accountants (AIA) also concurred in November, 1948, in this practice in its earlier Accounting Research Bulletin No. 37.

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It independently believed at the time that it was the best reporting treatment for compensatory stock options.

Now, the AIA takes the initiative to revise this reporting method by advising in its current Revised Bulletin No. 37 of January, 1953, that such corporations should take a deduction when the option is granted at fair market value. SEC objects to this treatment of stock options and recommends the perpetuation of its rule because the proposed new practice "would result in the almost complete exclusion from corporate income statements of charges for compensation to employees in the form of stock options; for most option plans are no longer of the unrestricted type and under the restricted plans the option price is fixed generally at market or within 95% of market."[1]

Fundamentally this controversy cannot be confined to the narrow issue as to what is the best method of reporting compensatory stock options. Actually it questions the respective authorities of SEC, AIA, and the courts in the matter of adequate reporting of income for public consumption.

Accounting income is conceived of as realized income without reference to changed money values and to fluctuations in the worth of non-disposed of assets. On the other hand, economic income is a much more inclusive and all-embracing term. It concerns itself with the disposal wealth one has between two dates without one being richer at the latter date, giving due regard to changes in money values, to going-concern value, and to realized and unrealized increases and decreases in the worth of assets. A reconciliation between these two concepts of income can be achieved in part by consistently rendering accounting data for both working and fixed capital more interpretative during deflationary as well as in inflationary periods by means of business indices. However, the gap between accounting and economic incomes cannot be bridged altogether because accountants record only transactional experiences, and ignore unrealized appreciations and depreciations in going-concern and asset values. Accounting science is primarily concerned with the measurement of income. The recent adoption by some taxpayers of the Last-In-First-Out (LIFO) method of inventory valuation in place of the First-In-First-Out (FIFO) method for tax and other reporting methods is a step in an effort to reconcile both views because the former more adequately reflects changes in the value of the dollar.[2]

Accounting principles are not relatively inflexible, unyielding and inexorable laws of nature like the law of universal gravitation which itself has undergone change at the hands of Albert Einstein. Accounting is a science in the sense that statistics is a science. Accounting data may therefore be arranged purposively to meet the needs of creditors, for example, in contrast to that of stockholders, government agencies, or employees. However, accepted accounting principles must respect pertinent statute and their final judicial interpretations.[3] Consequently we have diverse tax, Interstate Commerce Commission, Securities and Exchange Commission and other utili-

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[1] SEC Release No. 4803X, dated February 25, 1953.

[2] *Changing Concepts of Business Income.* Report of Study Group on Business Income. New York: Macmillan Co., 1952. *An Inquiry into the Nature of Business Income under Present Price Levels.* Arthur H. Dean, New York: American Institute of Accountants, 1949. *Business Income and Price Levels,* An Accounting Study, George O. May. New York: American Institute of Accounting, 1949. *Five Monographs on Business Income,* Sidney S. Alexander et al. New York: American Institute of Accountants, 1950.

[3] *Bulletin 23* of the Committee on Accounting Procedure of the American Institute of Accountants, entitled "Accounting for Income Taxes." *Release 53* of the Securities and Exchange Commission, entitled "Charges in Lieu of Income Taxes."

tarian bodies of special accounting principles.[4]

We have illustrated the influence of the Internal Revenue Code, as in the case of LIFO inventorying, and the Security and Exchange statutes, as in the case of compensatory stock options, on accounting science. These impacts were possible only because of the will of the legislatures through statutory enactments. There is no denying, however, that the self-governing accounting profession has historically exerted the greater influence in the interest of accurate and honest reporting for the public good. Its distress lies in the fact that government agencies have interpreted their own enabling statutes to vary from what it considers its expert, public-entrusted authority to promulgate fundamental accounting principles. Its aspirations are that the government agencies will conform with its accounting concepts in their respective efforts to fulfill the intent of the legislatures which created them. Note its attempts to prevail on Congress to enact tax laws predicated on accounting methods of reporting.[5]

Obviously, the existing SEC practice of permitting a corporate stock option deduction at fair market value when the executive qualifies is at variance with its tax treatment in the case of the compensatory variety which requires its deferment until its exercise. The defense of the independent practice of SEC in this regard is its enabling statutes of Congress which were enacted to protect the investing public. Without going into a study of the comparative merits of the above five likely events for deducting stock options, SEC in substance contends that its method of reporting this item is for the greater good of the investing public. And now that its method differs from the new AIA method of deducting the market value of the option at the time of grant, it challenges the latter's correctness in this procedure in the interest of the entire public.

In the absence of precise statutory language, no government agency has the right to devise its own accounting principles. To do so is to disparage the integrity and competence of the accounting profession, historically vested by the public with the authority to propound fundamental reporting principles for the common good. Accordingly, dissidents must yield to the thinking of AIA.

On the other hand, the new AIA proposal to deduct the fair market value of the compensatory option at the time of grant is provocative on another count. To commence with, it too is in conflict with the legally adjudicated tax treatment of compensatory stock options which requires the deduction at the time of exercise. More important, the AIA proposal of deducting the value of the grant is an unwitting espousal of "the economic benefit theory" which propounds the not too revolting concept that the incidence of taxation should be the enjoyment of economic benefits. This theory was revived by the 1945 United States Supreme Court decision in the famous *Smith* case[6] which happens to have dealt with compensatory stock options. The case is by no means authority for the proposition that the granting of an option is a taxable event, but it does discuss the likelihood of such a possibility on this resurrected principle. Soon after, the Bureau of Internal Revenue (BIR) found justification in this theory for levying an income tax on farmers' and manufacturers' chari-

[4] *"The Impact of Federal Legislation Upon Accounting,"* William W. Werntz, Accounting Review, April 1953, pp. 159-169; See also *The Influence of Administrative Agencies on Accounting,* by William W. Werntz, Iowa Law Review, Winter 1951.

[5] *Recommendations for Amendments of Federal Tax Laws,* January, 1953. Recommendation No. 1 of the American Institute of Accountants.

[6] 324 U. S. 177 (1945), and 324 U. S. 695 (1945). See also *Bruun,* 309 U. S. 461 (1940); *Midland Mutual Life Ins. Co.,* 300 U. S. 216 (1937; *Horst,* 311 U. S. 112 (1940).

table contributions of their inventories.[7] Heretofore, such contributions were income tax deductions measured by their market values at the time, but escaped the impact of income tax on their appreciations because the act of contributing was not a recognizable income tax event. Such reversal of BIR income tax practice as to contributions of inventories precipitated a most significant controversy which is reflected in the Griswold-Surrey-Bittker-Roehner-Miller dispute in the pages of the Harvard Law Review and of the Tax Law Review.[8] BIR is now also attempting to treat as taxable income the diverse "fringe benefits" offered to corporate employees on the same theory in almost complete renunciation of the earlier time-honored tax-free "convenience of the employer" concept. Note the recent changed attitudes of BIR with respect to what was formerly employee tax-free board and lodging, sickness benefits, and group life insurance benefits.[9] Nevertheless, the "economic benefit theory" is not as yet the undisputed governing tax principle of our country because the courts have not had adequate opportunities to pass on the propriety of the new practice of BIR.

Without taking a position as to the merits of the "economic benefit theory," it must be emphasized that *no court decision to date has taxed either the qualifying for or the receipt of a stock option grant.*[10] Accordingly, it appears that the SEC and the new Bulletin No. 37 of AIA are both at variance with settled tax law. Recognizing fully that SEC and the AIA have the primary functions of protecting the investors and the public at large, respectively, through reporting processes, how can they both disregard the fact that the courts have consistently held that compensatory stock options are taxable in the year of exercise measured by the spread at that time? SEC derives its authority from its enabling statutes and the adjudications thereunder all of which are designed to protect investors by obliging issuing corporations to make full and adequate disclosures. It is violating its trust to the public when it deviates from unequivocal pronouncements of the courts to the effect that the exercise date governs the timing of the accrual of compensation in stock options. Moreover, it should have greater consideration for the determinations of AIA as to what is accurate reporting because the latter is vested with the acknowledged expert skill in the interest of the greater common good, whether or not we differ with its pronouncements. Furthermore, the above SEC criticism of the new AIA Bulletin No. 37 on the score that,

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[7] I. T. 3910, 1948-1 C. B. 15; I. T. 3932, 1948-2 C. B. 7; *Broderick,* 104 F. Supp. 213 (D. Kan. 1952).

[8] Griswold, *Charitable Gifts Of Income and the Internal Revenue Code,* 65 Harvard Law Review 84 (1951); Miller, *Gifts Of Income And Of Property: What the Horst Case Decides,* 5 Tax Law Review 1 (1949); Bittker, *Charitable Gifts Of Income And The Internal Revenue Code: Another View,* 65 Harvard Law Review, 1372 (1952); Roehner, *Realization: Administrative Convenience Or Constitutional Requirement?* 8 Tax Law Review 173 (1953).

[9] Board and lodging may be taxable. Mim. 6472, C. B. 1950-1, p. 15, modifying Mim. 5023, C. B. 1940-1, p. 14. Sickness benefits may not be tax-exempt insurance payments. Bur. of Int. Rev. Information Service, No. I. R.-047, March 26, 1953, not following *Epmeier,* 199 F (2d) 508 (C.C.A.-7, 1952); also I. T. 4107, I. R. B. 1952-23, reversing I. T. 4015, 1950-1 C. B. 23. Group life insurance premiums are not additional taxable income if the contracts are current term and do not have paid-up or substantial values. Mim. 6477, Feb. 23, 1950, revising O. L. 1014, 2 C. B. 88 (1920), also Art. 33 of Reg. 45 (1920).

[10] *James M. Lamond,* Para. 46.023 P-H Memo T. C. (1946). *Van Dusen,* 8 T. C. 388 (1947), affirmed 166 F (2d) 647 (1948). *Norman G. Nicolson,* 13 T. C. 690 (1949) *Malcolm S. Clark,* 9 T. C. M. 719 (1950). *Bradner,* 11 T. C. M. 566 (1952). *Straus,* 11 T. C. M. 786 (1952). *Wahl,* 19 T. C. No. 81 (1952). *McNamara,* 19 T. C. No. 112 (1953). *Rosenberg,* 20 T. C. No. 2 (1953). *Hazelton,* Para. 53,123 Memo T. C. (1953).

if implemented, it would result in the almost complete exclusion from corporate income statements of charges for compensation to employees for stock options is specious. In guarding the interests of investors, it may decide before adjudication as to whether a stock option is proprietary, compensatory, or restricted. If it decides that it is compensatory, it is accruable only when exercised until the courts or the legislature holds otherwise. SEC is first beholden to the courts which explain the statutes and then to AIA which promulgates fundamental accounting principles for reporting.

AIA is also subject to criticism. It may in its judgment declare the grant date as being the proper accrual timing for compensatory stock options but not when the courts hold otherwise. It, like SEC, is not a law unto itself. Neither one is above the law of our country.

In sum, SEC practice making qualification for the stock option and the new AIA Bulletin No. 37 proposal making the date of the compensatory option grant the deductible event for the employer-corporation are not substantiated by law. They must alike respect the current tax law to the effect that compensatory stock options are reportable in the year of exercise. If they operate contrary to tax law, what treatment will they accord such options in the year of exercise? In addition thereto, SEC and AIA should require a complete and full disclosure of executive stock options whether they be compensatory, proprietary or restricted in the best interests of investors and the public at large. While SEC and AIA may hold that they need not give heed to the tax consequences of executive stock options, they cannot ignore them in so far as they constitute the law of the land.

# Regulatory Legislation

## A Special Report to the Membership

Solely in order to help in forming legislation plans and policy, the Board of Directors and the Committee on Legislation plan to survey the views of the Society membership on regulatory legislation this September.

This report has been prepared as background for the survey. The report is divided into three sections:

1. A brief statement of the major provisions found in a typical regulatory bill.
2. The principal arguments advanced for and against regulatory legislation.
3. A summary of the history of regulatory legislation in the various states.

Issuance of this report should not be taken to indicate that the Board and the Committee propose or oppose regulatory legislation. Neither has made a specific decision on one side or the other. The purpose of the report is to present a brief statement about different aspects of the regulatory question for the information of the Society membership.

### I—Major Provisions of a Regulatory Bill

In brief, the provisions of a typical regulatory accounting bill would do the following:

1. Enroll all bona fide public accountants as of a specified date.*
2. Limit future practice, (i.e. involving opinions on financial statements for third parties) to public accountants who had enrolled on that date, and to certified public accountants.
3. The intent is to have public accounting practice confined ultimately to certified public accountants, rather than to establish two permanent separate classes.
4. Bring all CPAs and enrolled public accountants under the same rules of professional regulation and conduct.

These provisions were included in the Society's regulatory bill which was defeated in the 1951 legislature. In addition, the bill contained a special provision for accountants who could not meet enrollment requirements when the bill was passed, but who might be expected to go into public accounting in the future.

Under this provision, specified groups would be allowed to file a "Declaration of Intent," reserving their rights to enroll if they should later enter public accounting. These groups consisted of accountants who for three years out of the ten years before passage of the bill had been engaged as: (a) individual public accounting practitioners or partners; (b) staff members of a public accounting firm or practitioner, or (c) government employees in accounting or auditing.

### II—The Pros and Cons

As often happens on a significant question, those who favor regulatory legislation are strongly in favor of it; those who oppose it take an equally strong stand.

Arguments pro and con have been presented to the Society membership

* One definition of a public accountant who could register is "any individual engaged, in good faith, as a principal occupation, on the date of the enactment of the bill, in the public practice of accountancy either as an individual practitioner or as a copartner of a copartnership engaged in the public practice of accountancy."

on a number of occasions—as articles in the Society magazine, in the form of special statements, or in legislation committee reports.

However, it seems worth while to sum up the arguments again for information purposes. The following summary attempts as objectively as possible to give the principal arguments on each side of the question.

### 1—Arguments for Regulatory Legislation

#### The Public Interest

The goal of a regulatory law is ultimately to bring under the same professional and ethical standards all accountants who offer their services to the public in work involving public expression of their opinion.

The public interest requires passage of a regulatory law for the basic reason that the present permissive law allows anyone, regardless of his qualifications or lack of them, to practice public accounting.

Under the permissive law, non-certified accountants do not have to meet any experience or examination requirements. They are not held by the State to prescribed standards of conduct. They may simultaneously engage in another business, whether or not it conflicts with professional accounting practice.

The informed public may be aware of CPA standards. However, it is the uninformed public—small business, the small investor—which needs protection most. Despite its efforts in the field of public information, the accounting profession can hardly be expected to explain the meaning of CPA standards to the increasingly larger number of people who, directly or indirectly, are coming to rely on accountants' services and statements.

In some instances, critics of a regulatory law have suggested that statutory recognition of non-certified men places them in a stronger position to compete with young CPAs who are starting out in individual practice. However, regulatory supporters have stressed the point that a regulatory law makes for fairer professional competition than now exists because it places non-certified men under the same rules of conduct as CPAs.

#### An Evolutionary Step

Passage of a regulatory law is an evolutionary step through which accounting must pass, just as other major professions have.

Today's permissive law does not conform to the pattern which has been set by older professions. The fact that only practitioners recognized by the State are allowed to hold themselves out as lawyers, doctors, dentists or architects, for example, is one of the essential reasons that they hold their high standing in the community.

Cases of malpractice do occur in all professions; it is one of the faults of human nature. However, malpractice in a regulated profession is punishable. Under the present permissive law, certified public accountants are governed by prescribed state rules of conduct, and by regulations governing malpractice. However, malpractice by a non-certified public accountant may go completely unpunished.

This is not to say that malpractice is common. But the point is that all persons practicing public accountancy, whose work includes giving opinions on financial statements for third parties, should be subject to uniform standards of professional conduct, and should meet the same standards of education and experience. That is the ultimate objective of a regulatory law.

#### Future Legislative Problems

Legislative problems will have to be faced by the accounting profession regardless of whether the profession has a permissive or a regulatory law. However, if the Society takes the initiative in promoting a sound regulatory law, it will be on firmer ground when future legislative conflicts arise.

Recent history has shown that legislative attacks on CPA standards may be expected regularly under the permissive law. Every year since the war, bills which would lower the standards for the certificate have been introduced in the New York Legislature. Some of these bills clearly had no chance of passage. Others had relatively strong backing. With the exception of the Oliver Law granting certificates without examination, the Society has successfully opposed every measure which would have lowered CPA standards.

Undoubtedly efforts may be made under a regulatory law to secure waiver certificates, or a reopening of enrollment. These efforts will be made no matter what type of law is on the statutes. The likelihood of their success will diminish as the profession becomes stronger and more widely understood and recognized. And it cannot reach its potential place of prestige and unity unless, through a regulatory law, all persons practicing public accounting are held to the same standards.

Experience in various other states shows that the non-certified accountants, as they have become better organized, have become increasingly interested in regulatory legislation. However, the types of bills which they have sponsored in many instances—and which have been passed in several states—are not bills which our Society would support. The fact that loose regulatory bills have been passed has been due in most cases to lack of timely organized effort by the CPA Societies. Put on the defensive by introduction of a loose bill by other groups, the CPAs have been forced to compromise and yield on such questions as qualifications for enrollment of non-certified accountants.

California has been pointed to as one state in which this occurred. The large number of enrollments of non-certified men resulted from loose enrollment provisions.

A study has recently been made to determine how many public accountants might enroll in New York State under a well-conceived regulatory law. It is estimated that 4,000 or more would meet the enrollment qualification of being in bona fide practice.

### Constitutionality

It is generally agreed that a modern regulatory law, in which the limitation on practice applies only to work involving opinions for third parties, is constitutional.

Although sections of regulatory laws were held unconstitutional in three early cases, the modern form of regulatory law was judged constitutional in the most recent case (Wisconsin, 1936). The decision pointed out that the Wisconsin law, unlike those questioned in the earlier cases, restricted practice only where third-party opinions were concerned. This is the pattern which recent regulatory laws sponsored by CPAs have followed.

## 2—Arguments Against Regulatory Legislation

### The Public Interest

The ultimate test of any professional legislation is whether it serves the public interest. As far as the accounting profession is concerned, the public interest is protected by the existing permissive accountancy law, and other laws which provide adequate remedies in cases of fraud or other serious misconduct.

No change has occurred in recent years which makes it desirable to pass a new basic form of accounting legislation. The Wilson-Brydges Law of 1952, which provides rules of conduct governing all CPAs practicing in New York State, represents a change under the existing law which furnishes additional protection of the public interest. It is also claimed, insofar as New York State is concerned, that a reasonable period of operation under the Wilson-Brydges amendment should be permitted before any major changes are made in the existing CPA law.

The present CPA law sets up a standard—the CPA certificate—which the informed public clearly recognizes. Businessmen, bankers, credit grantors, investors, and others who are the principal users of accounting services today know the meaning of the CPA certificate, and will become increasingly acquainted with its significance as the profession grows and its work in the field of public education expands.

Further progress in protection of the public interest depends not on regulatory legislation but on continued improvement of CPA standards and regulation—advances in accounting education and professional standards, and in self-regulation.

**Comparison with Other Professions**

The fact that practice in a number of other professions is limited to persons meeting certain prescribed standards does not mean that public accounting should be limited by law in the same way.

The purpose of state regulation of a profession is to protect the citizen who otherwise would be unable to protect himself. That is the basis for regulation of law, medicine and dentistry, to cite typical examples. Each of these professions touches very important questions of health or personal freedom of all classes of people.

Public accounting, however, does not affect the public in the same way. A public accountant's statement has little value to or influence on the person who is unable to understand it. People who normally need public accounting services, or rely on a public accountant's opinion, are sufficiently well informed to know the value of CPA standards. They do not need the type of protection which a regulatory law would purportedly give.

A regulatory law does not guarantee the elimination of incompetence or lack of integrity. Abuses may and do occur in both regulated and unregulated fields.

A law does not make a profession. The accounting profession has made tremendous strides during its relatively short history in this country. Passage of a regulatory law would not have the effect of suddenly accelerating the development of the profession's attainments and prestige. That development will depend entirely on the efforts of the men who make up the profession.

**Public Confusion**

One of the real dangers inherent in a regulatory law is that, by giving official recognition to non-certified public accountants, it will result in public confusion over what is or is not an "accredited" accountant.

Enrollment and registration of non-certified men may imply that they have been tested in the same way that CPAs are. Thus the publc may assume that there is little if any difference between the two classes. Public confidence in CPA standards would be seriously undermined.

This problem would be especially pronounced if a large number of non-certified accountants are enrolled under the regulatory law. In California, for example, the regulatory law permitted enrollment of many who had little or no public accounting experience. In 1952, the number of public accountants was nearly five times greater than the number of CPAs. Proponents of regulatory legislation assert that this would not occur in New York. However, there is always a possibility that it might; the danger is there whenever a regulatory bill is introduced.

**Legislative Difficulties**

A regulatory law may serve more to increase than to decrease the number of future legislative attacks on CPA standards. By granting recognition to non-certified public accountants, regulatory legislation opens the way to continual efforts to lower CPA standards —that is, to secure waiver certificates, rights to practice for men who have had no public accounting experience, con-

tinuing non-CPA registration and so on.

A regulatory law may very well be interpreted as precedent for subsequent moves by enrolled accountants who do not meet CPA requirements, or by non-enrolled men who cannot meet initial provisions for public accountant registration. For example, enrolled accountants would be in a strong position to ask for waiver certificates as CPAs on the grounds that the regulatory law gave them equal rights with CPAs as to practice but not as to title or state recognition. Organized non-enrolled men at some point in the future could use the first regulatory law as a base for requesting a re-opening of the registration provisions.

In short, a regulatory bill does not offer a cure-all for the CPAs' legislative problems; if anything, it opens the way to more problems than it solves.

### 3—Brief History of Regulatory Bills

Today, twenty states and two territories have regulatory accounting laws. The fact that the first of these was adopted in 1924 implies that the regulatory principle is of fairly recent origin. However, professional literature indicates that the idea of establishing regulatory laws followed fairly closely the passage of the first permissive CPA law in New York in 1896.

The opposition at that time was based on the belief that a regulatory law might have the effect of lowering public accounting standards. It was feared that any regulatory bill would lead to loose granting of waiver certificates. Many in the profession questioned the advisability of more government control than that which existed under the permissive law.

#### First New York Regulatory Bill

The first regulatory bill to gain strong backing in New York was that of 1924. Sponsored by The New York State Society of Certified Public Accountants, it was supported by organized non-certified public accountants in the state. The bill was passed by the State Legislature but vetoed by the Governor.

This bill differed in one important respect from those introduced more recently: it did not provide simply for enrollment of non-certified public accountants, but instead would have granted CPA certificates to them by waiver. Because of this waiver feature, the bill drew considerable criticism from the profession in other parts of the country.

The same bill was introduced in 1926 under Society sponsorship, but failed to pass in the legislature. Another regulatory bill was offered in the 1927 legislature. However, it was opposed by the Society on the grounds that the waiver provisions were too loosely drawn and would have given certificates to many persons who could not be classed as bona fide public accountants.

#### First Regulatory Law

Meanwhile, the first regulatory law was enacted in the 1924 legislative session in Maryland. In general, it was similar to "modern" regulatory bills. It provided for registration of non-certified public accountants on a specified date, and restricted future entrance into the profession to men who met CPA qualifications. It did not offer waiver certificates. In one respect, this and other early regulatory laws were somewhat different from those sponsored by state CPA societies more recently. The "modern" regulatory bill usually restricts practice only where the accountant's work involves opinions on financial statements for third parties. Many early regulatory measures were designed to include other services in the area of work which only CPAs and registered men would be allowed to perform.

Louisiana also passed a regulatory bill in 1924. Six more states—Florida, Illinois, Iowa, Michigan, North Carolina and Virginia—enacted regulatory

laws in the twenties. The Illinois law provided for a form of continuing registration of non-CPAs. Subsequently, in 1943, a new Illinois law was passed making non-CPAs a dying class. Four states—Arizona, Colorado, Mississippi, and Wisconsin—passed regulatory laws in the thirties; nine—California, Georgia, Kentucky, Missouri, New Mexico, Texas, Washington, Alaska and Puerto Rico—in the forties; and one, Oregon, thus far in the fifties.

Of these laws, nineteen make non-CPAs a dying class. Three, in Georgia, New Mexico and Alaska, provide for continuing registration of public accountants.

The nationwide legislative record shows particularly heavy activity in connection with regulatory or continuing two-class bills in the past few years. Since 1949, eleven regulatory bills supported by state CPA societies have been introduced; twenty-nine bills, most of them permitting continuing public accountant registration, have been supported by public accountants' groups.

### Recent Regulatory Bills in New York

After its bill in 1925 failed to pass, The New York State Society did not support another regulatory measure until 1939.

Drafted by the Society at the request of the Attorney General of the State, the 1939 bill failed to pass. In 1940, a bill was introduced by the non-certified accountants (with a provision for enrollment of governmental accountants). After being amended, it was supported by the Society. It was defeated in the legislature.

In 1944, a mail poll of Society members showed support of regulatory legislation by over ninety per cent of those voting. (Forty-four per cent of the membership voted.) As a result, the Society sponsored a bill in the 1945 and 1946 Legislatures. Both failed to pass.

The most recent survey of Society members' views was in November, 1950, prior to the introduction of the regulatory bill in the 1951 Legislature. Forty-six per cent of the membership voted on the question. Seventy-four per cent of the ballots were in favor of a regulatory bill, and twenty-six per cent opposed it. The 1951 bill, with which most members are familiar, was defeated in the Senate by four votes.

However, the provisions of the 1951 bill bringing all CPAs under state rules of professional conduct were enacted into law in 1952 in the Wilson-Brydges Law.

* * *

*Note:* The library of the American Institute of Accountants has prepared a bibliography on regulatory legislation. The Society office will be glad to send a copy to any interested member on request.

# New York State Tax Forum

*Conducted by* BENJAMIN HARROW, C.P.A.

**Non-taxable Liquidations—Section 354 (9)-a**

The 1952 Legislature introduced a provision in the law permitting a corporation to liquidate during one calendar month in 1951 or 1952, without subjecting the stockholders to a taxable gain on the liquidating dividend resulting from any appreciation in corporate assets. This provision is similar to Section 112 (b)(7) under the Internal Revenue Code.

One of the requirements in the law is a provision that the liquidation must be approved by 80% of the total voting stock. This proved to be a stumbling block to taxpayers seeking the benefits of this provision, since the stock might be held by non-residents as well as residents and the latter might hold much less than 80% of the stock. Fortunately the 1953 Legislature[1] came to the rescue of the taxpayer by changing this requirement to 80% of stock owned by resident stockholders.

In cases where a plan to liquidate had been adopted and residents owned less than the required 80% of the stock, the time for filing the election to postpone the gain was extended to August 1, 1953. This is a retroactive provision applying only to corporations that had liquidated in 1951 or 1952.

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Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is now serving as one of the Vice-Presidents of the Society and is also on the Society's Committee on Federal Taxation, and is past Chairman of its Committee on State Taxation. He is also a member of the Institute's Committee on Federal Taxation and its Council.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

**Franchise Tax—Deductions for Contributions**

There is no specific provision in Article 9A with respect to a deduction for charitable contributions. One basis of the franchise tax is entire net income, which presumably is the same as net income reported under the federal income tax law, with certain specified exclusions and inclusions. Tax-exempt interest, for example, is includible in entire net income. A net operating loss deduction is excluded from entire net income. The exclusions and inclusions make no reference to charitable contributions.

It may well be argued[2] that the 5% limitation for charitable contributions under the I.R.C. is not applicable to any extent under Article 9A, although the Tax Commission assumes that the same limitation does apply. Under the I.R.C., the 5% limitation is affected by a net operating loss deduction. Does the same limitation apply under Article 9A?

In our opinion, the net operating loss deduction cannot affect the 5% limita-

[1] Laws of 1953, ch. 571.

[2] New York State Income and Franchise Taxes (Second Edition)—Harrow; Prentice-Hall, 1951, p. 91.

tion for charitable contributions, assuming such limitation is to be taken into account to any extent in arriving at entire net income, for the reason that the net operating loss deduction is excluded in arriving at entire net income. If entire net income is higher than net income reported under the I.R.C., an adjustment for charitable contributions is proper where the 5% limitation has been applied.

### Credit for Income Taxes Paid Other States or Countries

Under the New York income tax law a non-resident taxpayer may take a credit for taxes paid other states or countries, provided such state grants substantially similar credit to residents of this state (Section 363). This provision appears to be equitable in so far as other states make such reciprocal provisions. However, if a taxpayer receives any income from foreign countries which is taxed at the source, the New York law allows neither a deduction nor a credit for the tax paid. The result is that a taxpayer may actually pay out in taxes more than the income he receives.

An actual case recently was called to our attention. A taxpayer received income of $1,163.60 from England. The British tax amounted to $1,101.60. The net income actually received by the taxpayer was $62.00. The New York tax on the income of $1,163.60 was $69.40, so that the total British and New York State taxes amounted to $1,171.00.

Such an inequity obviously requires some correction in the law. All the taxpayer actually receives as a New York resident is $62.00. Before the foreign income can reach the New York resident, the foreign jurisdiction collects a tax. The reality of the situation requires New York to consider what income actually comes within the jurisdiction of New York. In the case of residents, the State exercises jurisdiction to tax on the basis of domicile or residence, and in the case of nonresidents it has jurisdiction to tax on the basis of the place where the income is earned. Where an individual subjects himself to tax in more than one state on different theories of jurisdiction, it would seem that the domiciliary state should make the equitable adjustments to avoid inequities.

If this situation cannot be resolved administratively the law should be changed at least to allow a deduction for income taxes paid to other states and countries. The problem does not arise under the Internal Revenue Code, since a deduction from gross income is allowed for state taxes paid, and a deduction or credit is allowed for foreign income taxes paid.

### Exemption of Veteran's Property from Real Estate Taxes

Property purchased with the proceeds of a veteran's pension money is exempt from tax up to $5,000.00. Pension money includes bonus payments, insurance policies or refunds. The property may be owned by the veteran himself, his wife, his widow if she does not remarry, a dependent father or mother, or minor children. To be eligible for the exemption the pension money must be applied to the purchase of the property, but the money need not be specially earmarked. It may be mingled with other funds.

The law[3] extended the exemption to real estate purchased with moneys collected by popular subscription for disabled veterans of World Wars I or II or of Korean hostilities. The 1953 Legislature[4] extended the latter exemption to $10,000.00 "to any seriously disabled veteran . . . who has received pecuniary assistance from the United States Government toward the acquisition of a suitable housing unit with special fixtures or movable facilities

[3] Tax Law, Section 4(5-a).
[4] Ch. 490, effective April 4, 1953.

made necessary by the nature of the veteran's disability. . . ."

The exemption from real estate taxes does not extend to school or highway taxes. To obtain the exemption the veteran or relative eligible for the exemption must claim it by filing an application with the tax assessors on or before the date set for protesting the assessments for taxation placed upon the property (grievance day).

The exemption applies if eligible funds are used to reduce the principal of a purchase money mortgage, or if the funds are expended for actual improvements that increase the value of the property.

### Gross Receipts Tax—Interstate Commerce

In the case of foreign corporations engaged in the operation of transportation facilities and carrying on some business in New York in connection with their interstate commerce, how much local activity will subject them to the General Business and Financial Tax? The comptroller has sought to tax such corporations no matter how small the activity was in New York City. To avoid the contention that the tax discriminates against interstate commerce, which fact would make the tax unconstitutional, the Regulations introduce an apportionment formula. This formula contains a provision that even under the formula, at least 12½% of allocated receipts shall be subject to tax. Large corporations find this tax quite burdensome and so it is not surprising that the tax is being resisted. Three cases recently were decided by the lower courts of the State on the issue of the constitutionality of the Gross Receipts Tax, all of them in favor of the taxpayers. Most likely the decisions will be appealed and we await with interest the action of the Court of Appeals, particularly since there was a dissenting opinion in two of the cases. In the meantime the facts merit analysis.

### Gross Receipts Tax—*National Steel Corporation* v. *City of N. Y.*[5]

In this case the corporation asked for a declaratory judgment that the General Business and Financial Tax Law did not apply to it, and that as to it the laws contravene the Constitution of New York and of the United States. The corporation also sought to recover taxes paid by it under protest for the years 1950 and 1951.

The corporation is a Delaware corporation that manufactures and sells steel processed in West Virginia and Ohio. In New York it maintains a selling office. Salesmen attached to the office solicit business in New York, New Jersey and Connecticut. All orders are accepted at the home office and the product is shipped F.O.B. the factory to the place specified by the buyer. The corporation has never filed a certificate of doing business in New York State.

The city first moved to dismiss the complaint on the ground that the Administrative Code provides a procedure for refund. On this point the court said that an action for a declaratory judgment may be maintained, in spite of the provisions of a taxing statute providing that the methods of judicial review prescribed in the statute shall be exclusive, where the statute is being challenged as unconstitutional, or where the tax laws are inapplicable to the taxpayer. That was the situation in this case.

On the interstate commerce issue, the court said that the business of the corporation was exclusively interstate and the tax was levied against its right to carry on interstate business. Everything the corporation did in New York was in furtherance of its interstate business and none of it constituted or contributed to the doing of a local business. The court cites a number of the familiar leading interstate com-

[5] Supreme Court, Special Term, Part V, New York County—N.Y.L.J., p. 1429, April 29, 1953.

merce cases[6] and the opinion is worth reading for the analysis of these cases. The court makes clear that solicitation by salesmen entitles a foreign corporation engaged in interstate commerce to the immunity of interstate commerce from tax. That is not a local incident that can be carved out of the integral economic process of interstate commerce. The court did not find it necessary to go into the legality of the apportionment formula.

### Gross Receipts Tax—
### *United Air Lines, Inc.* v. *Joseph*[7]

In this case a foreign corporation engaged in interstate commerce had one of its chief terminals in New York. It sold passenger tickets in New York City in an amount equal to what it sold outside the city. In New York City it operates three traffic offices, a hangar, a stock room of parts and supplies and a repair and maintenance shop. It employs about 300 persons in the city including a district traffic manager. As an accommodation or by-product it also sells some parts of airplanes and provides maintenance for other air lines. Such sales average about $12,000 in annual revenue. Also, as a member of Airlines Clearing House, it may sell passage on the lines of other members. It may thus sell tickets for passage between points within the state of New York, although its own planes do not fly within points in the state.

Out of total passenger revenues ranging between 18 and 27 millions of dollars, the City considered as allocable the sales receipts for passage to or from New York City irrespective of where the passage was purchased. This amounted to 5 or 6 million dollars and, under the allocation formula, a minimum of 12½% was subject to the tax. The City argues that the vast business establishment within the city and the many local activities constitute a localizing of its generally interstate operations, and that the corporation is therefore subject to the Gross Receipts Tax on a reasonable apportionment basis.

The majority of the court did not agree with the Comptroller. The court said that "the activities of United Air Lines in New York City was simply a continuous, logical and necessary extension of its interstate air transportation." The size of its New York activities merely reflected the size of its interstate operations. New York City was merely an important land, sea and air center of transportation. The fact that an interstate transaction starts or stops in a state does not localize it as a state transaction. The court was of the opinion that this case was analogous to the *Spector* case and then proceeded to analyze the activities of United Air Lines, Inc., in the light of the *Spector* opinion. It then said that "when the activity of the taxpayer involves a combination (or a mingling) of intrastate and interstate commerce, a gross receipts tax will be held valid if the burden of the tax is reasonably and approximately allocated to that portion of its activities which are severable as intrastate." The opinion quotes at length from Justice Stone's opinion in *Western Live Stock* v. *Bureau*[8], and emphasizes the fact that in order to apportion a privilege tax on interstate commerce, there must first be some local or intrastate commerce. It notes that this case "was a markedly liberal extension by the Supreme Court of the power of the state to apply local taxation to enterprises involved in interstate commerce, so long as there was no threat of a multiple tax burden."

In the *United Air Lines* case, said the court, there was no mingling of intrastate and interstate commerce. All

6 *Ozark Pipe Line Corp.* v. *Monier et al.*, 266 U. S. 555. *McLeod, Commissioner of Revenue* v. *J. E. Dilworth Co. et al.*, 332 U. S. 327. *Pudget Sound Stevedoring Co.* v. *Tax Commissioner*, 302 U. S. 90. *Joseph, Comptroller* v. *Carter & Weekes Corp.*, 330 U. S. 422. *Spector Motor Service, Inc.* v. *O'Connor*, 340 U. S. 602.

7 App. Div., First Department, May 12, 1953.

8 303 U. S. 250.

the traffic is interstate and all the local activities "are nothing more than the necessary incidents to operating a terminal point for its interstate transportation to and from New York City." The court agrees that the income of $12,000 for services to other airlines was "perhaps intrastate in form", but under the *de minimis* doctrine, that should not be a justification for subjecting to taxation and apportionment millions of dollars of interstate receipts. On the apportionment formula the court says that no apportionment can be fair because there is no ratio of intracity receipts and interstate receipts. One of the factors must be zero and hence no formula with a minimum (12½% of allocable receipts) can be fair. It should be noted that the corporation did pay a gross receipts tax on the revenue of $12,000.

Mention should be made of a dissenting opinion by Judge Callahan. He disagreed with the court's application of the *de minimis* rule. Even if the intrastate activity represented only a small percentage of the total business, there was sufficient local activity to subject the corporation to a local privilege tax on the gross receipts, including receipts from interstate commerce, if the tax was properly apportioned.

### Gross Receipts Tax—*United Piece Dye Works* v. *Joseph*[9]

In this case the taxpayer was a foreign corporation that printed and dyed greige goods in New Jersey. The greige goods come from mills in New England to the plant in New Jersey and after processing are reshipped at the instructions of customers. The bulk of the customers are in New York City. The corporation has a 5-story building in New York City from which it services its accounts by advice, sales promotion, advertising and claim handling.

The City claims the right to impose an apportioned gross receipts tax for the privilege of doing business in New York City. Receipts from customers in New York City regardless of where delivery was made were treated as allocable receipts. The City contended that the services rendered by the corporation were a continuous unitary operation localized in New York and taxable on an apportioned basis.

The court held for the taxpayer on the ground that the New York activities are exclusively interstate commerce. The services rendered in New York were called incidental and insubstantial in so far as they do not relate directly to the interstate operations. They merely promoted the interstate activities. In New Jersey the corporation employed 1,100 persons. The New York office employed 13 persons in soliciting and promoting services of the corporation. The advice and promotion to attract an outlet for its customers was considered as part of its selling activites.

In its reasoning the court refers to the *Hans Rees' Sons* case,[10] which arose in connection with the validity of a statutory apportionment formula under a North Carolina franchise tax law. In that case a manufacturer in North Carolina bought raw materials outside the state and sold the finished product through a New York office. Only the manufacturing was done in North Carolina. The court held that North Carolina could tax only the allocable income from the manufacturing part of the business. Its profits arose from purchases, manufacturing and sales in a unitary business. Manufacturing was deemed to be localized in North Carolina. The income from sales came from contracts made in New York and the purchases from another out of state operation. The court felt that the instant case was not like the *Hans Rees* case since the New

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9 Appellate Division, First Department, May 12, 1953.
10 283 U. S. 123.

# Accounting at the S. E. C.

*Conducted by* Louis H. Rappaport, C.P.A.

### SEC Eases Statement Requirements for Prospectuses Used More than 13 Months

The SEC has recently revised its rule relating to "bring-up" prospectuses which has the effect of easing materially the requirements for financial statements included in such prospectuses.

When a registration statement under the Securities Act of 1933 becomes effective, the prospectus (which forms part of the registration statement) may be used in the usual case for 13 months after the effective date of the registration statement. After 13 months have expired, the law provides that the information in the statements contained in the prospectus shall be brought up to a date not more than 12 months prior to the time of use of the prospectus, so far as the information is known to, or can be furnished by, the user without unreasonable effort and expense. In the case of offerings which take place over an extended period, such as stock being issued upon conversion of bonds or preferred stocks or through exercise of warrants or options, the law requires the preparation of successive "bring-up" prospectuses to be used in place of the one issued when the registration statement became effective.

In 1947, the SEC promulgated its Rule 427 dealing with information to be included in "bring-up" prospectuses; this is the rule that has now been revised. The old rule stated, in part, "information contained in a registration statement may be omitted from a prospectus used more than 13 months after the effective date of the registration statement insofar as information on the same subject, *including certified financial statements,* as of a date not more than 12 months prior to the use of the prospectus is contained therein". (Emphasis supplied.)

The demand for the inclusion of certified financial statements, which was contained in this rule, was a requirement that in some cases was more stringent than the requirements imposed in the case of the original registration of the securities. For example, in the case of a registration statement which is filed within 90 days after the close of a company's fiscal year, financial statements at the end of the fiscal year need not be certified provided certified financial statements as of the close of the preceding fiscal year are included. In the case of registration statements relating to offerings being made over an extended period such as those previously referred to and where, as a result, successive "bring-up" prospectuses are required, compliance with the rule necessitated more than one audit a year because of time required to prepare and audit financial statements. Thus, the rule had the practical effect of making "bring-up" prospectuses usable not for 12 months but for some shorter period. These circumstances led to numerous proposals for amendment of the rule. Effective June 3, 1953, the SEC promulgated an amended and less restrictive rule. The text of the amended rule follows:

*Rule 427. Contents of Prospectuses Used After 13 Months*

(a) There may be omitted from any prospectus used more than 13 months after the effective date of the registration state-

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# Office and Staff Management

**A forum for the exchange of views and information on all aspects of the administration of an accounting practice.**

*Conducted by* MAX BLOCK, C.P.A.

### Administration Manuals

Well-managed businesses have learned that job manuals pay off very well on the time, effort, and expense invested in them. Many large accounting firms have emulated their efficient clients; so have some smaller accounting firms. A large segment of the medium- and small-sized firms (based on number of staff members) has, however, done relatively little in this respect except as to audit programs. Manuals for administrative jobs, such as report-typing, proofreading, report-reviewing, tax return preparation and checking, and other office functions have received scant attention.

There are a number of deterrents to the preparation of job manuals, namely, the considerable time involved in their preparation, the difficulties involved in standardizing procedures, the lack of personnel qualified to undertake such projects, and, not the least important, the failure to realize the substantial benefits to be realized.

Dealing with the last of the deterrents first, the following major advantages of job manuals in an accounting office are brought to the notice of accountants who do not utilize them.

MAX BLOCK, C.P.A. (N. Y., Pa.), is a former chairman of the Committee on Administration of Accountants' Practice of the New York State Society of Certified Public Accountants. He is a lecturer at The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.

1. The development of standard procedures (providing flexibility where needed) will cause a review of prevailing practices. As a consequence, their adequacy and efficiency will undoubtedly be inquired into. This will probably be like a tonic to those firms who have not previously found time for the development of the most effective, coordinated procedures, or who have just been lax. Improvements undoubtedly will be effected by every firm, no matter how well managed, after such an analysis.

2. After manuals are in effect, the hiring of new employees will not present nearly as serious a "breaking-in" problem as otherwise. Regardless of an employee's experience, he would be given a copy of the manual for his job, to read and digest. This will speed up his orientation immeasurably, give him greater confidence, minimize questions, reduce errors and embarrassments, and save the time of those who do the breaking-in.

3. The manual provides a reference record when questions are raised as to policies in force and how they are carried out. Lapses in specified procedures, and inconsistencies, should be considerably lessened when manuals are on hand, and mandatory review at reasonable intervals is provided for.

4. Where several employees perform similar functions, greater uniformity will be attained when each uses the same guide and instructions.

The foregoing advantages are so considerable as to warrant well the investment in the preparation of manuals. Even a very small firm will find them

useful, to relatively the same extent as a much larger firm.

As to the first three deterrents specified, their seriousness fades in the light of the benefits to be realized. Moreover, source material is now available for guidance in the preparation of manuals. This should remove most of the dread of undertaking the project of preparing them. Finally, staff utilization on such jobs can be satisfactory and save the time of principals.

In this column in subsequent issues, specific reference to source material will be made and other helpful hints offered.

### Records in Evidence

A bulletin of the New York Credit & Financial Management Association (May 14, 1953) noted the passage of a new law bearing on the use of records in pre-trial testimony. Previously, records could be demanded by a subpoena duces tecum, but their use was limited to refreshing the memory of the witness. Now such records may be received in evidence. For accountants this means that records subpoenaed from them may have to be left with the referee or other hearing officer, rather than retained in their own possession during the time of the examination.

### CPA Reciprocity and Temporary Practice Rules

There is a considerable lack of uniformity in the rules of the various states as to CPA certificate reciprocity and temporary practice. This condition is discussed in the April, 1953, issue (P. 474) of the Journal of Accountancy. While the variances are not specified as to the individual states, their extent is made clear. This should serve to forewarn accountants whose services cross state lines to inquire into the foreign state laws on accounting practice.

The summarization of the rules of the various states was based upon an investigation by the American Institute of Accountants. However, the Institute report states that tabulation of the findings was impractical because of the diversity of the replies. It is hoped that this disclosure will spur action to make state laws uniform throughout the country.

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## New York State Tax Forum

(Continued from page 467)

York activity was nothing more than solicitation and promotion.

Again Judge Callahan dissented. He thought the local servicing activities were substantial and separate from the commerce. He even went so far as to observe that "it is difficult to say whether the transportation of the goods between states was anything more than an incident of the service." In any event he thought the services were separable and extended beyond mere solicitation and promotion. The mere dying of the goods was minor to the service in having goods made up into attractive shades and patterns. Then too the corporation maintained an adjustment bureau in New York City to handle complaints as to finished products. In addition the corporation creates a market for the converter's goods by national advertising. This enables the converters to effect local sales to garment manufacturers. All in all, thought Judge Callahan, there is much more in New York than solicitation and promotion. There is at least partial performance of the whole enterprise by activities of a local nature not directly part of the interstate commerce. He even thought that the *Hans Rees* case supported the validity of the gross receipts tax.

We are inclined to agree with the dissenting opinion in both cases, particularly this one, and therefore we shall await with interest the action of the Court of Appeals.

# Payroll Tax Notes

*Conducted by* SAMUEL S. RESS

### Recent New York State Unemployment Insurance Decisions

A very interesting decision from the procedural point of view was handed down recently. In the normal course of events the employer involved in the unemployment insurance dispute might have considered himself foreclosed from pursuing further his contentions that he was not liable for the amount of contributions alleged and found to be due from him in accordance with a prior holding by the Referee and the Appeal Board sustaining the Industrial Commissioner's determination. The Industrial Commissioner had levied a $341.52 assessment against the employer for contributions alleged to have been due from March 1st, 1947, through the fourth quarter of 1949.

The Appeal Board had ruled that the employer could not appeal from the Referee's decision, sustaining the Industrial Commissioner, because more than 20 days had elapsed between the date of filing the notice of appeal and the date of the Referee's decision. The employer made an application to the Appeal Board requesting a reopening and reconsideration of its decision. The Board reconsidered, pursuant to the provisions of section 534 of the Unemployment Insurance Law, stating

> ". . . Any hearing, inquiry, or investigation required or authorized to be conducted or made by the board may be made or conducted by any individual member thereof, and the order, decision, or determination of such member shall be deemed the order, decision or determination of the board from the date of filing thereof in the department, *unless the board on its own motion, or on application duly made to it to modify or rescind such order, decision, or determination*" (italics ours).

The Appeal Board on reconsideration of this case then went on to find that the employer was not liable for the full amount of the assessment. (Appeal Board case #36-362-53, May 29th, 1953.)

In this instance the Appeal Board held that it was within its power to disregard section 621.2 of the Law, which requires employers to file their appeals from unfavorable Referee decisions within 20 days. This case may be used as authority for taking an appeal after the 20 day period has passed. The safest course is to file before the 20 days have run.

### $10 Penalty Assessment Reversed

In practically every instance where the Industrial Commissioner's determination that a $10 penalty had been incurred by an employer for not complying, within 7 days, with the Commissioner's request for employment information (pursuant to section 575.4 of the Labor Law), the employer's appeal to the Referee or the Appeal Board has been unsuccessful.

It is therefore of interest to note that in Appeal Board case #36,513-53, decided on May 29th, 1953, the Industrial Commissioner's appeal was denied

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by the Appeal Board, and the Referee's decision cancelling the $10 penalty assessment against the employer was sustained.

### Office-Worker's Service Bureau Held Liable for Contributions

The Appellate Division of the New York State Supreme Court, Third Department, held that a General Office Service Bureau was liable for unemployment insurance contributions on the earnings of individuals that they referred for special jobs in different establishments. (Appeal Board Case #23,700-50, affirmed May 13, 1953.)

Office workers were supplied to clients on a part-time basis. Contact with such workers was made through newspaper advertisements in the "Help Wanted" columns. Prospective workers were interviewed at the Bureau office and filled out cards indicating their training, experience, time available, and preference of locality for work. The cards were filed by the Bureau which fixed the hourly rate of pay for work. There was a spread between the rate charged the client and the pay-rate to the worker.

When a client called for help, the Bureau went to the files and referred the worker with the required qualifications for the period of time requested by the client. After the assigned work was completed the worker reported to the Bureau the time of the engagement and the client was billed at the agreed rate. The worker was paid each week by the Bureau at the basic rate for the number of hours worked.

Withholding and Social Security taxes were deducted. There was no direct oversight and control of the work done, or of the worker. It was held that on the basis of the record there were sufficient facts to sustain the Appeal Board's finding that claimants were in fact employees of the Bureau. The power of the Appeal Board to modify or rescind a decision on its own motion pursuant to section 534 of the Law was likewise sustained, although in this case it worked to the employer's disadvantage.

## Accounting at the S. E. C.

(Continued from page 468)

ment any information previously required to be contained in the prospectus insofar as information covering the same subjects as of a date not more than 12 months prior to the use of the prospectus is contained therein.

(b) Every such prospectus shall contain the latest available certified financial statements as of a date not more than 12 months prior to its use except that, where the last fiscal year of the registrant has ended within 90 days prior to the use of the prospectus, the certified financial statements may be as of the end of the preceding fiscal year provided uncertified financial statements as of the latest practicable date are included in the prospectus. If uncertified financial statements are included in a prospectus pursuant to this rule, certified financial statements as of the end of the last fiscal year shall be substituted therefor or added to the prospectus when available.

(c) Twenty copies of every prospectus used more than 13 months after the effective date of the registration statement shall be filed with the Commission pursuant to Rule 424 (c).

The effect of the amended rule is to permit the use of unaudited financial statements as of the latest practicable date and certified financial statements as of the end of the preceding year in cases in which the need for the use of a "bring-up" prospectus occurs within 90 days of the close of a company's fiscal year. It should be noted that when certified financial statements as of the close of the latest fiscal year are available, they must be substituted for the unaudited financial statements or added to the prospectus.



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